SMALL BUSINESS' ACCESS TO CAPITAL: IMPEDIMENTS AND OPTIONS

104

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Small Business' Access to Capital:...

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

WASHINGTON, DC, FEBRUARY 28, 1996

Printed for the use of the Committee on Small Business

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SMALL BUSINESS' ACCESS TO CAPITAL: IMPEDIMENTS AND OPTIONS

WEDNESDAY, FEBRUARY 28, 1996

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Jan Meyers (chair of the Committee) presiding.

Chair MEYERS. Good morning.

Our hearing this morning is the first in a series that this committee will hold over the next few months on small business' access to capital. In this morning's hearing, we will endeavor to identify "the problem," that is: What are the current conditions and availability of capital for small businesses? What are the specific obstacles and opportunities that small businessmen and women face in this area?

Once we have clearly defined the problem, the committee will explore in future hearings specific capitalization options such as bank lending and venture capital. Let me also say at the outset that this series of hearings will focus on sources of capital available through the private sector. We are not looking for another Government solution to what is a bad problem. While there are numerous Federal Government programs designed to facilitate small businesses in meeting their capital needs, these programs can not and should not be the sole source of financing for a small business.

Moreover, the American people, and especially small businessmen and women, have made it clear that Government should be smaller, less burdensome, and less intrusive. Therefore, I believe it is important for us at this juncture to explore ways that the private sector can marshall its resources and innovative talents to meet a greater part of the capital needs of this country's small businesses.

This issue is also not just important to small business, it is critical for the country as a whole. For instance, in 1994 small businesses accounted for — and I was really amazed at this statistic — 99.7 of the Nation's employers. They employ 54 percent of the private work force, contributed 52 percent of all sales in the United States, were responsible for 50 percent of the private gross domestic product, and produced an estimated 62 percent of the new jobs in that year.

These are extremely impressive statistics that could never have been achieved without capital. In addition, given the fact that capital access is often the toughest for small firms, it is extraordinary that these businesses are able to accomplish so much with so little.

Historically, men and women seeking to start a small business have relied on their personal savings and individual credit to get the business off the ground. As the business grew, the owners reinvested their earnings, utilized trade credit, looked to bank loans as financing for expansion.

In recent years, however, the level of bank lending to small businesses has declined in large part because of stricter bank regulations and increased paperwork burden and compliance costs. As a result, small business have increasingly had to turn to other sources in the private sector to finance future growth and development. So, it is not surprising that the delegates to the 1995 White House Conference on Small Business made capital formation one of their very top priorities.

This morning we will hear from five witnesses representing individual small businesses, as well as small business organizations. I have asked the witnesses to provide the Committee with their insights as to the current and historic private-sector sources of capital available to small business and the specific obstacles and opportunities that exist in these areas.

It is my hope that this hearing and the follow-on hearings will accomplish two things: First, identify some of the regulatory impediments, which, if remedied, will allow the private sector to provide better access for small business. Second, open a forum for new ideas in order to stimulate the innovative genius of the private sector and develop new alternatives that will enable small businesses to continue their valuable contribution to our national and local economies.

At this time I would like to recognize my neighbor from Missouri, Mr. Skelton.

[Chair Meyers' statement may be found in the appendix.]

Mr. SKELTON. Thank you very much.

In the absence of Mr. LaFalce today, the ranking minority member, who could not be here and would love to be here, I would ask unanimous consent to put his opening statement into the record, which I might point out the very first sentence compliments you.

Chair MEYERS. Then we will certainly want to put it into the record, without objection.

[Mr. LaFalce's statement may be found in the appendix.]

Chair MEYERS. At this time any of the other Members who have statements will be allowed to put them in the record, without objection. We will go to our testimony from our witnesses, and our first witness.

Our first witness is Murray Gerber, president and CEO of Prototype and Plastic Mold Company of Middletown, Connecticut, and he is representing the National Association of Manufacturers.

TESTIMONY OF MURRAY A. GERBER, PRESIDENT AND CEO, PROTOTYPE & PLASTIC MOLD COMPANY, REPRESENTING NATIONAL ASSOCIATION OF MANUFACTURERS, MIDDLETON, CONNECTICUT

Mr. GERBER. Thank you.

Good morning, ladies and gentlemen. My name is Murray Gerber, president and owner of Prototype & Plastic Mold Company, a small manufacturing company in the plastics business, in Middle-

town, Connecticut. We are a 27-year-old, family owned S-corporation with 80 employees. I am a member of the NAM Board of Directors and am a former chairman of the Connecticut Business and Industry Association.

The National Association of Manufacturers is the Nation's oldest and largest broad-based industrial trade association. It has nearly 14,000 member companies and subsidiaries and that includes approximately 10,000 small manufacturers.

We are in every State and produce 85 percent of U.S. manufactured goods. Through its member companies and affiliated associations, the NAM represents every industrial sector and more than 18 million employees. That is the commercial.

I have also been Small Businessman of the Year twice in Connecticut, Small Business Advocate of the Year twice, and a delegate to all three White House Conferences on Small Business.

We appreciate the opportunity to testify regarding the problem of small business access to capital, and to discuss not only personal experiences but our suggestions for improving the access of smaller capital-intensive manufacturing companies.

As I indicated, I have served in several capacities as a representative of small business. While I speak to you of my personal experiences, I am also acting as a spokesman and advocate for many, many small businesses.

For the most part, my knowledge is Connecticut-based. I suspect Connecticut is an extreme case, because of the long recession, changes in the banking environment, and the many bank failures and mergers.

I think Connecticut experience is helpful in understanding the global situation, where we might go. In the complete package of my testimony, I make the case that there is a shortage of credit for small business, and that the credit crunch we have been talking about for the last several years continues. It continues despite the fact that the banks advertise availability of funds and claim the problem is an absence of demand.

To understand the situation, you should consider there has been a dramatic shift in the credit environment. Small business has learned it is not going to satisfy its need for capital from the banks. It has sought out other sources such as nonbank banks or it has gone on a diet and is living with less than it needs or it has done without altogether.

The situation with startups is critical. Loans for capital-intensive startups are virtually nonexistent. The consolidation of banks has left us without local bankers that knew our fathers and our grandfathers. There is no such thing as a "character loan" anymore.

I believe we are in a transition period where nontraditional sources of credit are coming in to fill the void left unsatisfied by the banks. Indicators of this credit shortage abound.

From the increasing demand for SBA guarantees through the increasing demand for loans from the nonbank banks, statistics would show the decrease in small industrial and commercial loans and the precipitous drop in what the banks call small CRE, "commercial real estate" loans.

The fact is that bank small business loan portfolios are disproportionately small compared to the small business contribution to the gross domestic product, and getting smaller.

The smaller staffs in the banks are a sign of sickness, and the fact that small business people almost universally say there is a shortage of credit. These objective hearings, I am sure, will convince you the shortage is real.

I hope I have a few seconds more, because I would have to pass up this my first opportunity to testify without saying something about the most important issue to me as a small business person, and that is, the desperate need for remedy in the S-corporation tax rules and also the AMT, which is punitive to companies that are capital-intensive.

We desperately need the cash that would be saved from help in those areas. It is as good as reduced interest on loans. In the long-term, having the small business job generating sector capitated will result in fewer jobs, less growth, and lingering economic concerns.

I thank you for permitting me to speak and for holding these hearings. I hope to be able to bring out some more detail in response to your questions.

[Mr. Gerber's statement may be found in the appendix.]

Chair MEYERS. We thank you very much for your testimony, Mr. Gerber.

Our next witness is Robert Smith, president of Spero-Smith Investment Advisers, Inc., representing National Small Business United.

TESTIMONY OF ROBERT SMITH, PRESIDENT, SPERO-SMITH INVESTMENT ADVISERS, INC., REPRESENTING NATIONAL SMALL BUSINESS UNITED, CLEVELAND, OHIO

Mr. SMITH. Thank you, Madam Chairman.

My name is Bob Smith, and I am a partner in Spero-Smith Investment Advisers in Cleveland, Ohio. I am also the chairman of the Credit and Capital Formation Committee of National Small Business United, and also serve on the Board of COSE, the "Council of Small Enterprises," of the Greater Cleveland Growth Association, which is the largest local small business organization in the Nation. COSE is also a member of National Small Business United. I also do appreciate the opportunity to testify today on this important issue.

As a small business owner and an investment adviser of small businesses, I can tell you the importance of small business capital formation and financing cannot be overstated.

In the late 80's and early 90's, bankers got much more risk-averse brought on by increased regulation, especially in the Northeast, and by the recession that therefore created a credit crunch.

Contrary to my colleague, I believe the access to capital situation has improved dramatically. Although I am concerned about what happens with the next credit crunch, our position initially would be to let us make sure that all the things in place now with the SBA and their guaranteed financing stays in place; and if necessary, during the next credit crunch, let us make sure money is increased to step in where the private sector is not doing a good job. There is need for improvement before the next credit crunch.

The unique thing about small business is the tremendous diversity in size and businesses and the needs of businesses, and it makes it very difficult, as you know, to get your arms around the problem. Consequently, we believe that it is appropriate to look toward small incremental steps as opposed to one, single solution.

If I could comment on some personal experiences, in 1988 some partners and myself made an attempt to buy out the firm in which we were working. Our initial contact was with a venture capital firm. We were investment advisers, and the learning curve we went through was still very steep.

The final conclusion was the money was available, but the cost was too high. I think many small business people when they first start venturing and looking at venture capital can see the tremendous monies that could be available, they get excited by that.

As they go through the process, however, the situation becomes either they just do not qualify because the opportunities are not great enough, or, because what they have to give up, in terms of equity ownership, are too high.

The next experience I had was when, we did start our own business, as opposed to buying out the existing business and chose to use bank financing to obtain our monies. There we learned the valuable lesson of personal guarantees.

When the banker said to me, when we were frustrated about these guarantees, "As long as I have more money in this business than you do, and you have the stock, you are going to personally guarantee this loan." I had to gain respect for that position.

National Small Business United in conjunction with the Arthur Anderson Enterprise Group did conduct a study, which you have before you. The results of that study confirm this diversity issue and the complexity of the situation. I will not bother to highlight anything; but if you read my testimony, the facts and figures are there, and I would encourage you to look at that.

We do offer some solutions, and there are four of these. The first one has to do with the capital gains tax. We support the broad-based capital gains rate reduction that is currently on the table. More importantly for us, we would encourage lower rates with increased holding periods. We think that would go a long way toward lining up the equity ownership and time horizon with the rate reductions from which the owners would benefit when they sell their business.

We also support the privatization of the SBIC. We understand and appreciate the leadership provided by Congressman Torkildsen on this issue. By privatizing we believe there would be a better balance between the incentives of the private market and also the incentives to address the need for quality control of those people in the business.

We encourage greater bank lending; however, we are not encouraging more regulation in this area. We want to compliment the Chair's leadership by requiring banks to monitor and show the evidence of their support for small business loans.

We believe that organizations like National Small Business United and especially on the local level, organizations like COSE, can provide leadership in meeting with local banks and holding them accountable for their statements in the media about their commit-

ments to the small business market, and then post-auditing versus what they are actually doing.

The last solution, we would offer is at times we talk a lot about the tremendous pools of money in the institutional marketplace, and it looks very inviting. The lack of liquidity and marketability of small businesses makes it difficult to visualize how that money can be accessed. We would encourage the securitization or packaging of small business loans in secondary markets to facilitate that.

In conclusion, I just want to thank you for your interest and we offer any other support as you study this important issue to small businesses.

[Mr. Smith's statement may be found in the appendix.]

Chair MEYERS. Thank you very much, Mr. Smith.

Our next witness is William J. Dennis, Senior Research Fellow at the NFIB Education Foundation, and he is representing the National Federation of Independent Business.

TESTIMONY OF WILLIAM J. DENNIS, JR., SENIOR RESEARCH FELLOW, NFIB EDUCATION FOUNDATION, REPRESENTING NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. DENNIS. Thank you, Madam Chairman.

Let me preface my remarks by suggesting that the ability to obtain and to retain capital is extraordinarily important. Most businesses start with their personal wealth and most can only expand if they have some type of retained earnings.

This implies that something has to be done on the tax and regulatory side. While neither the topic of the hearing today, I think it is important that we start there and at least have it as part of the discussion.

Most small business owners can get most of the capital they need most of the time. What allows me to say that? NFIB does a lot of surveying, as you well know, and virtually ever survey we conduct supports this assertion.

For example, we have a monthly periodical based on a survey that we conduct called "Small Business Economic Trends." One question we ask is something to the effect, "Were you able to satisfy all of your borrowing needs in the last 3 months?"

Over the last year, the ratio has been five who have been able to satisfy all of their borrowing needs for every one who could not. Of course, we did not include those who were not in the markets. That is simply one example.

In another, "Small Business Problems and Priorities," we took 75 potential problems and asked a large sample to rank them: The ability to obtain long-term business loans was their 46th most serious problem out of 75; the ability to obtain short-term loans, or revolving capital loans, was 53rd; and equity capital was 69th out of 75.

Also, financing small business starts is easier than many think. I emphasize "than many think." The reason I say that has to do with things like second mortgages, personal loans, the switch to a service from a manufacturing base, which means that the amount of capital required to go in is less. We have a number of secondary wage earners these days, dual income families help, and so on.

Nonetheless, this having been said, there are gaps. Gaps are the things that the Committee should address — not the general overall picture, but gaps.

I have listed six gaps, and I would like to go over them briefly. The first is starts. Now, for a couple of reasons that I have mentioned, it is not as difficult as some would think. Indeed, we are starting millions of new businesses every year. Nonetheless, there are critical problems, particularly in the larger small starts.

A larger small start may be, oh, the type that would employ 10, 15, 20 people. For people entering these types of businesses, indeed there is a serious problem. I am not sure it is a debt problem, however. It is probably an equity problem. Already we have something called "angel investors." They are putting between $10 and $20 billion in this type of business as well as growth business.

Perhaps the most knowledgeable person in the country is Professor Wetzel at the University of New Hampshire, and you have probably had him before you at some point in time. He estimates that twice that amount of capital could be easily absorbed if the market mechanisms were functioning efficiently.

What about venture capital? Well, venture capital does not fund startups. It does not really fund much under $1 million. We cannot include venture capitol in the start phenomenon.

The second and probably the other really critical area is rapidly growing businesses. Again, this is a real problem for a banker. You have to understand how rapidly growing businesses grow. They do not grow in a straight line. They grow like a sine curve, up and down, a snake may be a better way to describe it.

For a lender, that become a very, very difficult problem. How do they know when a little downturn may not be the last downturn? What makes these so difficult is that a growing business is a voracious consumer of capital. They need it not only to maintain current operations, but they need it for expansion. They are always behind.

Since growing firms are really a major job generator, they are one of the things that distinguishes the United States from virtually the rest of the industrialized world, this is a critical class of business and one that needs to be funded. It probably can only be done through increased equity.

The third type of shortage is due to business cycles. Someone on the panel earlier mentioned some of the cyclical problems. Balance sheets deteriorate as the cycle goes down. Indeed, NFIB data show direct relationships, direct inverse relationships, between the growth in the economy and the capacity to access credit markets. It is very clear. That is a problem. Many who cannot obtain credit in these periods are very good businesses; they just temporarily are having a little difficulty in the cycle.

Fourth is transitions. During the late eighties and early nineties we had the New England problem. As someone once said, it is very difficult to borrow when the bank doors are locked shut. That is kind of what happened in New England. Clearly, that was a very serious situation, but one at that time confined to that particular region. Earlier, the Southwest had seen a very similar thing.

There is also a second example, and a little bit more localized. It involves mergers and acquisitions. Although, I just saw a study

that was released by the Fed which I have not had a chance to read it. The New York Fed suggests that merged banks do a better job at lending to smaller firms than do nonmerged banks. I am going to be very curious to take a look at the argument put forward.

Fifth, there are marginal borrowers. There is always a line between someone who can get credit and someone who cannot. That line can frequently be a very, very fine line. The objective is not to change that, because that could never change. The objective is to move the line, if you will. Move the line toward the acceptance side.

Finally, the sixth is troubled businesses. There are some businesses for which further debt and equity just are not appropriate. Let me leave you with that. My time is up. I will be happy to answer any questions when the appropriate time comes.

Thank you.

[Mr. Dennis' statement may be found in the appendix.]

Chair MEYERS. Thank you, Mr. Dennis.

Our next witness is Ms. C. Virginia Kirkpatrick, who is president of CVK Personnel Management & Training Specialists, representing the National Association of Women Business Owners and probably also representing herself from her experiences in small business.

TESTIMONY OF C. VIRGINIA KIRKPATRICK, PRESIDENT, CVK PERSONNEL MANAGEMENT & TRAINING SPECIALISTS, REPRESENTING NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS, ST. LOUIS, MISSOURI

Ms. KIRKPATRICK First of all, I want to thank Mrs. Meyers for her help in small business. We really are very sorry that you will not be returning in the future.

Chair MEYERS. We have counted you as a great friend to small businesses.

Ms. KIRKPATRICK. I do own a small business in St. Louis. I am also a director on the Financial Services Council of the National Association of Women Business Owners. I am also a director and a shareholder in a new startup bank in the St. Louis area and sit on that loan committee. I may not be popular because I may have some of that banking aura, I am not sure.

The sources of capital for small business have already been discussed. The primary one is personal savings and then friends and family. Especially for women business owners, these sources are the major sources: A second mortgage on your home, the equity in the home if you can get your husband to sign. These are major sources.

The second in my experience has been that small businesses absolutely depend on SBA-guaranteed loans. I am on the board of St. Louis Steel Products in St. Louis. It is about a $12 million annual revenue company that took over a closed rolling mill, a steel rolling mill. They are in business primarily because of the 504 Program. I see that constantly, 7(a) for ongoing operations, LowDoc loans, prequalified loan programs. There is a great dependence in the small business community on these loans.

Women business owners use their credit cards more than any other source after family, friends, and personal savings, and home equity in their home. Generally speaking, women business owners still do have more credit problems than men. I realize that may not sound like a popular thing to talk about, but it is definitely true.

Most women-owned businesses at startup are undercapitalized, and it severely limits the growth that they can have. The small business with 2 or 3 years of successful operation does not have any trouble getting bank loans, they really do not. There may be some up and downs, but bankers are smart enough to figure out what is going on in a business. They do not have any trouble getting loans. It is startups that are difficult. They cannot get bank loans.

I think there have been some changes in the trends in the Midwest, certainly in the St. Louis area. I think those have been a matter of degree, not dramatic, significant kinds of change.

I work as a consultant with a lot of small businesses. My personal observation is that the availability of capital of the small businesses who are ongoing and have established some track record depends primarily on the competition for loans in the area. There is tremendous competition right now in the Midwest among banks for customers, for deposits, for loans. That competition is a healthy thing; it is a good thing. What it means is that many businesses are able to get loans at below prime rates, which is kind of a new thing since I have sat on a loan committee. Also, the regulatory environment which has been mentioned has a tremendous impact on the banks' willingness to make loans. You can never forget that.

Right after the S&L debacle, banks just had to look very, very carefully. Their loans were scrutinized with a magnifying glass and loans that were not fully — and I mean 100-percent-plus — collateralized were criticized. The regulatory environment, it cannot be overemphasized that they have tremendous impact on whether or not banks are willing to make loans.

Currently, I think that the environment in the Midwest, and I think St. Louis in particular, is very good for customers. There is a lot of competition among the banks, and I think that is healthy for the customers.

If you look at sources of capital, as we have been discussing, and you talk about securities offerings, my experience has been that working with the bank where we needed more capital, and we talked about an IPO, an "initial public offering," we found that cost $1 million. I do not know any small businesses who have a million dollars to go out and issue an IPO. We ended up registering our stock on the NASDAQ Exchange on the over-the-counter market, and that cost about $80,000 in legal fees.

The securities industry is not set up for small business at all. I understand that the laws are set up to protect the investor. I can understand that very well, but it is just out of the reach. It is not a factor at this point in time in the small businesses.

Venture capital has already been mentioned. They do not want to talk to anybody who wants under a million, and most of them do not want to talk about a million. I mean, they want to talk about $10 million perhaps, but they do not want to talk about smaller amounts of money. Venture capital does not provide capital

for small business in amounts that are $250,000 or under or $1 million or under. High-potential companies, technologically high-potential and/or "niche" markets, small companies can get startup capital from venture capital firms. It has to be a very unusual kind of business.

To my knowledge, institutional investors like insurance companies just do not provide any kind of capital for small business. They do not have any kind of incentive to. Why would they? They can take the large projects and make more money, and have it cost them less to do investing; so, there is no incentive to do that.

Some very quick recommendations. H.R. 2806 was introduced in the House on December 18, 1995. This bill would amend the SBIC Act and create the Venture Capital Marketing Association, "Vicky Mae," if you will. This mechanism would make it possible for small business loans to be securitized in the Fannie Mae fashion in the residential housing.

We already have the model; we know how to do it. I guess I do not quite understand why it cannot get done. It is a very positive thing for small business and for capital for small business. We need to continually be looking at regulatory environment.

Collateral is not — I sit on a loan committee — the source of repayment. An ongoing business that is profitable is the source of repayment of loans. Banks need to be able to make those kinds of loans. Frankly, you can blame the banks if you want, but not when the regulatory environment discourages making loans that are not over 100 percent collateralized. We need to be paying attention to that.

I also believe that banks need to be able to offer insurance and mutual funds and stock, et cetera, to their customers because the margins between the deposit rate and the loan rates are narrowing and narrowing and narrowing. We can make the banks the villain if we want, but they are not going to make loans if they cannot make profits.

In the end, I think we need to have incentives, and I think that incentives are much better than regulations. They cost less, and, in the end, they create more capital.

Thank you.

[Ms. Kirkpatrick's statement may be found in the appendix.]

Chair MEYERS. Thank you very much, Ms. Kirkpatrick.

Our final witness is a friend who has been with us before, John Satagaj, president of Small Business Legislative Council.

TESTIMONY OF JOHN SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Madam Chairman.

Before I start my testimony, let me also add, given I do not know when I am going to get a chance to testify again before you this year, thank you for all your good work and leadership. On behalf of SBLC and myself personally, it has been a terrific experience, and we are sorry to see you go. Take me with you, will you?

Chair MEYERS. Thank you. I appreciate that.

Mr. SATAGAJ. I think I will start with saying what Denny has said about startups is certainly true across the board, and I would agree in terms of starting up a small business.

I am not going to go back into that whole area, except to observe that in my experience it really comes down to three things if you are going to invest equity capital in a startup for small business: It is a relative, I am going to make a killing on this thing, or my accountant tells me I am going to get a tax break. That is what it really comes down to if you are going to make an equity investment in a small startup business.

Now, there is not much we can do about who you marry. In terms of that option, it is just chance. My wife came from a small business, and she married me. I guess she did not do anything for the business.

A sure thing? There is only taxes and death. There is no chance that we can guarantee that people can make a profit on an investment in a small business.

It comes down to the tax code. I have heard many comments here today about it. Certainly, capital gains is a big part of that. We are of the school that no matter how much you cut taxes, you have got to steer the folks to where you want them to go.

We have always believed throughout our organization's long history that you need to use the tax code in that way, whether it is rollover for small business or direct expensing, something that motivates them to go in a specific direction is as important as simply cutting the taxes. If we are looking for more equity investments in small business, we need to do that.

Second item, you asked in your testimony, "Well, let us have some historic data." Denny and I qualify as prehistoric when it comes to Washington. I have only seen this done once, where someone attempted to give a snapshot of where businesses get their capital. This is for small corporations. This is not a startup; this is an ongoing business.

According to this snapshot, which comes from 1978 and 1980, 55 percent of their capital came from internal sources and the remainder from external sources, this is as opposed to large corporations which only had to generate 43 percent internally. It tells you how dependent small businesses are on their own resources; this is an ongoing business. Of that, 37 percent came from depreciation.

In other words, I am making my profit, and I have got a write-off when I make the investment in my plant equipment, the quicker I can write it off, the better. If there was ever a case for direct expensing, this is it. Thirty-seven percent came out of depreciation, about 14 percent out of retained earnings. Murray talked about the S-corporation and the taxes on them, retained earnings. That is a big chunk of money.

Actually, when you look at it, shareholder loans were another 5 percent. It was actually 60 percent that was really coming from internal sources, because shareholder loans are my money, as the owner, going back into the business.

The remainder was: Short-term debt about 14 percent, that is the working capital loans or lines of credit; other capital about 2 percent; and long-term debt about 12 percent. That was a snapshot of small business in 1980. My guess is it is pretty much the same.

If I had to ask some of the business owners here, they would probably tell me that the trade debt is down. You do not get that kind of credit anymore if you are in the line somewhere. Everybody

is a little tighter with it. Equity capital is probably up for small business a little bit; depreciation probably has gone down some.

Since this period, it went up and went down. This is 1978 to 1980. It is a general snapshot of what we have. Small business is very dependent on internal sources for their resources. Anything we can do to expand other avenues of debt or equity for them will help them out quite a bit. Changes we can make in the depreciation area will help. That is where we are in terms of ongoing businesses.

In terms of bringing new funds in, I am part the baby boomer generation. Every time I pick up "The Wall Street Journal" I find out I am doing what everybody else is doing: I am putting my money in mutual funds; right? We are pouring it away like crazy. As much as I hate to say it, it is time we started shaking "me" down and tap those resources in mutual funds and pension funds.

Now, we have a long history of protecting those and the fiduciary responsibility of fund managers. I will probably regret it when I look at my pension and my funds years down the road, but I think it may be time to take another look at that and loosen the standards up, to encourage some investments in small businesses from those sources. Even though I am putting my own capital at risk here, I am willing to do it.

In terms of the stock market and the securities, as I mentioned here in 1978 and 1980 outside capital was about 2 or 3 percent. I am sure it has increased since then, but I do not lose a lot of time and sleep over whether we are going to get into those markets. As Virginia pointed out, it costs a whole lot of money.

As long as there are good lawyers around like me, it is always going to cost a lot of money because we are not giving that away. It is great if we can do some things around the margins to get more folks into the IPO's, but it is not where we should be spending our time.

In terms of the credit crunch, I think things are much better. Unfortunately, Murray lives in Connecticut — in fact, from my home town — and things are a little worse there than the rest of the world, but overall things have improved. We are doing a good job, and I think we are wringing out as much as we can.

We can use a few gimmicks like Jere Glover's report on banks and how they are lending to squeeze a little more out of the banks, but we are doing a pretty good job overall. We are big fans of the community banks. The more we have of those, the better off we believe we are.

Finally, I would mention, even though we are only talking about private programs here, I think we are on to something here with the SBIC Program and the changes that were made in 1992.

I think we are getting new equity capital from sources we did not get before, and that is what is important to me — and it is new money. From that perspective, I think we have made some serious progress.

I thank you for the opportunity to testify. I will give your counsel a copy of this chart that I read from.

In our era of downsizing, we have had to make many cutbacks everywhere. As you know, we all swallowed hard and we had to make cuts in the SBA and particularly economic research. Since

1982, the Chief Counsel's Office has been issuing a "State of Small Business Report."

If you want some interesting data on small business financing, that report for the last 14 years has had a whole section on small business financing. This happens to be from the 1984 report. I have not seen it done since then.

Unfortunately, we had to make those cutbacks in the programs over there, but it is a marvelous source of research. Denny has got as much money as any of us in the small business community to do research, and it is a pittance. We need to have it to be able to tell you the things you need to know. Call this a commercial message for good research.

Thank you, Mrs. Chairman.

[Mr. Satagaj's statement may be found in the appendix.]

Chair MEYERS. Well, thank you very much. I think our witnesses were all just tremendously interesting and obviously very well-informed about the problem, and I thank all of you.

I think I will hold my questions until the end. I would like to start the questioning with Mr. Skelton. Then I will recognize Members in the order that they were here. Although, Ms. Kelly had to leave briefly, she returned, and so we will go to Ms. Kelly next.

Mr. SKELTON. Thank you.

Mr. Gerber, I want you to assume that Joe Dokes lives in Tightwad, Missouri. Joe Dokes has a small manufacturing plant making basic widgets. He lives in a $75,000 home paid for. He has eight employees each of which makes a nice salary, and he pays himself $50,000 a year, and there are a few dollars left over from his widget business, but not much.

He has the opportunity to make a new kind of widget that the widget experts in the country say, "You are going to make a killing on this. These are wonderful people who do not want to buy the old; they want to buy the new widgets."

He goes to Bill Skinflint, the president of the Tightwad Bank. He explains that, "I have this widget, and I need a $300,000 loan to expand my small plant."

Bill Skinflint, the president of the bank says, "Look, Joe, you have the finest reputation in town. You have paid every bill I have ever known on time or ahead of time. Everyone likes you, but the days of giving a loan based on good character are over. Based on good character, you could have whatever the bank has because you are golden, Joe."

Joe leaves the Tightwad Bank with a heavy heart, and he says, "I have got a friend named Murray Gerber."

He gets him on the phone and says, "Murray, what are we going to do? I have an opportunity to make a real business decision that is just outstanding. I have this brand new widget. Help me, Murray."

What are you going to do? What are you going to say to him?

Mr. GERBER. I have a lot of difficulty reaching for somebody in Tightwad, Missouri.

Mr. SKELTON. Would you believe there is really a Tightwad, Missouri, and there is a bank known as the Tightwad Bank?

Mr. GERBER. Yes. I would believe it wholeheartedly.

Mr. SKELTON. Would you believe that many people throughout the Nation deposit money there so they can write a check on the Tightwad Bank.

Mr. GERBER. Great marketing.

Chair MEYERS. I do not believe, however, that the president of the bank is named Bill Skinflint.

Mr. SKELTON. No. What are you going to tell this fellow. He needs capital, and he cannot get it where he thought he could. He does not know anybody in St. Louis like a Ms. Kirkpatrick or anybody in Kansas City. What are you going to tell him?

Mr. GERBER. I think your description is an absolutely perfect description of the problem of entrepreneurs raising capital today, because he is not going to get it not only from the Tightwad bank, but from any other bank without having twice the collateral that he wishes to borrow.

He is not going to be able to borrow that money from a bank. Clearly, with a $75,000 house and a $50,000 income, he is not going to be able to satisfy the banker's requirements in terms of what is in a new venture fairly risky. Calling Murray Gerber is probably——

Mr. SKELTON. No, this is a pretty good widget. He has some letters from widget experts saying that this is a pretty good widget.

Mr. GERBER. It does not matter, because there is still risk. There is no history of cashflow; there is no history of sales for him making that widget; so he has a real problem. Calling Murray Gerber is probably the best way this fellow has of raising the capital, but he is going to have to call more than one Murray Gerber because Murray Gerber is not going to have the cash to give him $300,000. What you might do is get 4 or 5 Murray Gerbers or 6 that will put $25,000 apiece in.

Mr. SKELTON. How does he do that? You are the only guy he knows.

Mr. GERBER. I am sure that in a successful business he has customers, he has family members. We all belong to trade associations. I am sure he is not he only successful business in Missouri. If he knows Murray Gerber in Connecticut, he is also going to know a few others like me.

My point is that raising capital out of the private sector is probably his best way. It would be wonderful if he could access and if I could access some part of my 401(k), so that I could give him or lend him some money for a small business startup like that.

He can put together $150,000 and go to Mr. Skinflint and say, "Now I have 50 percent equity in this. Will you loan me the other $150,000?" It is not likely to happen. He is going to have to come in with 80 or 90 percent equity, and this is my problem with the banks. If they could also have some incentive for lending this man some money, he could raise that money. It used to be raiseable; it is not anymore.

Mr. SKELTON. At what point in our recent history did the loans based on good character disappear?

Mr. GERBER. I know when it happened in Connecticut. It happened in Connecticut when the regulators moved from Texas to Connecticut, and fresh from their success down there finding bogeyman in the banking business, they brought it into Connecticut.

You know, up until that time, I will admit we had to exercise some discipline as small business people not to take all the money that was being offered to us. I certainly am not recommending we go back to those kinds of times. Some place between those late 1980 kinds of operating conditions and what we have got now, there is a better place for small business to be able to fund its growth.

Mr. SKELTON. Does anybody want to add to that?

Ms. Kirkpatrick?

Ms. KIRKPATRICK. Could I add to that?

Mr. SKELTON. Yes.

Ms. KIRKPATRICK. At the point where bankruptcy laws became so easy and so common, that is when character loans became less likely to be made because for some reason it became okay to take bankruptcy and to leave your debts unpaid. As far as I am concerned, you cannot use bankruptcy in many instances in disqualifying somebody from a loan. That is part of the problem. It goes back to the lawyers.

Mr. GERBER. Can I stick in another word? Because from my standpoint, the thought of bankruptcy is absolutely not within my lexicon. It does not exist. One of the reasons I work 6 to 7 days a week in my beloved little business is for the fear of bankruptcy.

If you are talking about character loans, what are we talking about? We are talking about characters who will not contemplate going bankrupt. I think that bankers who have the ability to judge character would be able to see it in me, and millions of others like me. Bankruptcy is not one of the options they would consider.

Mr. SKELTON. Thank you very much.

Chair MEYERS. Thank you, Mr. Skelton.

Ms. Kelly?

Ms. KELLY. Thank you. I want to say, Mr. Gerber, I work like you do, and I have worked the same way. I am absolutely scared to death. Anybody in my family business — we will not go bankrupt. We absolutely will pay back everything.

I think that, Ms. Kirkpatrick, there are people who do agree with you. I just want to say that most of us who are small business people are there because we love what we do, we believe in ourselves, and we are willing to put out our blood, sweat and tears to make sure that our businesses work. I just feel that it is really important to say that up front, because that is where I am coming from.

I would like to ask anybody on the panel, there are a couple of things that have come out here this morning, and that is, that we are moving away from our ability in small business to go into a bank and get loans; that is, the ordinary sector where we used to get loans. We are moving out to loans from nonbank sources: Insurance companies, broker houses, pension funds, and so on, venture capitalists.

I would like to ask basically three separate questions about that. What is different about the way these people are willing to give you a loan when an ordinary bank would not? The second question is: What are the problems and obstacles you have with getting the capital from these sources? Third, how can we as Federal officials help you have access to that money? Because I do not see in the

near future the banks being out there to help us a whole lot right now.

Mr. GERBER. Thank you. May I take a whack at that first? First of all, what is different? The nonbank banks — and I have made a big issue of this in the full text that I gave you — are different because they operate with a different set of regulations.

Now, I do not think the banks are bad, and I do not really want to condemn or criticize banks and bankers, but the fact is they are not cutting it these days. They are not performing their function in our economy. I think in Connecticut they were driven there by muscular regulators of whom they are now scared to death, gun-shy, and regulator-whipped, to be honest with you.

The nonbank banks do not operate under the same set of conditions. Frankly, most of the good old bankers that used to exist in the Connecticut banks are finding themselves positions in the nonbank banks. They are able to make the judgments, they are able to make the decisions. To the extent that they have capital, they are able to make the loans.

The problems and obstacles with nonbank banks are, with the exception of some like Merrill Lynch and AT&T Small Business Credit, which are both operating in Connecticut, they have an absence of capital to invest. They do not have sufficient capacity to take care of all of small business loans.

In cases like Merrill-Lynch and AT&T, I think the problem is that small businesses do not know that they can go and get their capital from them. I think that I mentioned that we are in a transition period.

Small business will learn and will learn quickly enough, but for the next 5 or 10 years I think what we could do is help to speed this process along. Your third question was how to —? I put down how to, but I do not remember. I am sorry.

Ms. KELLY. How do you see us giving you some help on this?

Mr. GERBER. How to give help? I think from the Merrill-Lynches and the AT&T's, I do not think that you can. We have to do it ourselves amongst our associations. Let small business people know that they can go these places to get their capital needs satisfied.

From your standpoint, I think that you can help to pass some of the White House Conference issues with regard to bringing up capital from pension funds, from 401(k)'s, and from other sources of safe capital.

I think you can help make funds available to nonbank banks such as small business investment companies and — there is another name? — CPC or something, Capital some kind of company. These companies are getting their money from the private sector, and you can help loosen that up.

Ms. KIRKPATRICK. Could I comment on what is different? I am giving my time to a minority-owned beauty school on the north side of St. Louis, which is the most blighted area of St. Louis. She got money at 20 percent. It has absolutely ruined her because she has paid more interest than principal over a period of years, and cannot pay it.

One of the differences is that there are different regulations here and there are different credit criteria. For them it is OK if they

lose now and then, because they are already making so much money.

Chair MEYERS. Did she get money from a nonbank bank?

Ms. KIRKPATRICK. From a nonbank bank at 20 percent. It is killing. I mean, it is not a good source because of that, so it is different all right.

Chair MEYERS. If others of you would like to comment, that is fine. Otherwise, we will go on to Mr. Poshard?

[No response.]

Chair MEYERS. Mr. Poshard?

Mr. POSHARD. Thank you, Madam Chairman.

Just by way of a little anecdotal experience. When I was a kid following my father around, who owned a small farm, he used to go into the community bank and sit down and get the character loan for his operating expenses. He paid it back in the fall. People knew him.

Today, that same bank is owned by a large bank headquartered outside our State. The people who work there do not have any flexibility for character loans, even if we allowed it. That is gone by the wayside now.

Most of what people do in terms of banking in our small communities anymore is send money outside the area to be invested in God knows what ways by large banking institutions who do not allow the personal relationships with people in the community, to any extent at least.

Ms. Kirkpatrick, you said something interesting which begs another argument. You said it would help if banks could sell insurance, mutual funds, and so on, so that they could make more profit, ostensibly to offset some of the risk that they assume by making loans to small business people or so on.

Do you think we should allow banks to do that, or would they actually use that additional money for other things that would not go back into financing small business loans? Does anybody want to comment on that?

Ms. KIRKPATRICK. Fee income is becoming more and more a source of income for banks because of the shrinking margins for banks. If you have to set up loan loss reserves, it is difficult to do that. All I am saying is less regulation, more openness in terms of what banks can do for their customers is a positive thing. The banks that I know want to loan money.

Mr. POSHARD. Yes.

Ms. KIRKPATRICK. I mean, they really do. The problem is we have to figure out some ways that we can make it work and that we do not have a regulator looking over our shoulder saying, "That is a bad loan."

Mr. POSHARD. Exactly. I have probably 50 insurance agents in every town who do not want the banks to get into that business. I am just wondering what type of flexibility we have.

Yes, Mr. Dennis?

Mr. DENNIS. May I make a suggestion? Through tradition, most small business loans, if you look at the numbers, are between 1 and 3 percent over prime. I mean, that is where the huge majority of those loans are. Why? What is wrong with a little bit riskier loan paying prime plus four or prime plus five. The issue is availability.

The issue is not price until after availability has been assured. In the example of the lady paying 20 percent, she could not afford a 20 percent loan. If the risk merited that she pay 20 percent, then a loan is not a viable option. It seems to me that one of the emphasis, one of the things that the banking community has to start thinking about is how can they expand that interest rate window. In every business that I am aware of, you adjust price for risk. I know that my son started driving yesterday, my teen-age son. Let me assure you that the insurance industry adjusted price for risk. The banks do not do that. They adjust risk for price. I am lost. Interestingly enough, it is not just in the United States. It is in Canada, Britain, Australia, virtually everywhere. It is like a universal trait. One of the potential ways to make everybody happier, including the banks who will get additional business, is to allow those margins to expand. Allow the rates to fluctuate to a much greater degree.

Mr. POSHARD. Mr. Dennis, I appreciate that. I agree with you, actually. Let me just make one further point on this. By way of discussion, I do not expect you folks to comment on it necessarily, but I also represent, quite a part of my district are African-American communities, minority communities, and so on.

Now, you referenced the 20 percent rate in a minority-owned beauty shop in St. Louis County. If we think it is a real problem to have accessibility to cash in small businesses, you ought to see what the folks in the minority communities have to go through to access that same availability. It is unreal.

We all should be dealing with this, because a lot of these folks do not stand a ghost of a chance of getting their own business going. Now, we can sit here and argue all day about whether Government ought to be doing something to make that more available.

The banks gripe their heads off about having to divert any substantial part of their assets to loans in those communities. What in the world are we going to do? That is a real problem.

Small business is 85 percent of the jobs in this country. It ought to reflect that in our communities, irrespective of the economic conditions there, and it does not.

It is 10 times worse for people in those areas to have any kind of accessibility to cash, even if they have the best character in the world and even if they have nothing in their background to suggest that they cannot make the payments or anything else.

Madam Chairman, it is a real problem. I think we all recognize that. While we have made allowances in the Small Business Administration to try to help, something has to take place in the banking industry to make that more possible. I really believe that. You will have to adjust my time, Madam Chairman, but you folks are welcome to speak.

Mr. SMITH. Madam Chair and Congressman, let me just say that in Cleveland, we have that same issue. COSE, has a very successful and long-term history with our Small Business Development Center. We have just recently opened a new branch in Glenville.

What we are hoping to do is work closely with that community, educating them about the risks of entrepreneurship, helping them become more bankable and leveraging our credibility to the banking community to help fix this problem.

Mr. POSHARD. Thank you.

Chair MEYERS. That is an outstanding example. I am very impressed with COSE not only in what you have just said, but in what they have done with health insurance.

Mr. Gerber?

Mr. GERBER. Madam Chairman, I would like to make a few points about what Congressman Poshard said.

Without diverting this into a debate on whether banks should sell insurance or not, but I think you raise a very good point about what they need the profits from insurance for. I think they ought to better tend to their business.

I have an article here from "The Hartford Current," from Sunday, and the title is, "Banks' interest in customers dips as banks rack up profits." The point of this is that the banks are making a great deal of money now with their reduced staffs and with their reduced amount of loans to the small business, so that I cannot go along with what I heard about banks having such tough times.

The other point, the second point, is an article from "The New Haven Register," pertaining to nonbank banks. There is a statement in here that says that loans from nonbank bank are traditionally smaller or lower in costs than they are from banks. That is one of the things that they have the bring to the table. I will be happy to make these things available to the Committee.

The third thing is with regard to 20 percent interest rates, I would like to tell you that in my own history back in the early eighties when interest rates, when the prime rate, was in excess of 18 percent, that Prototype bought a state-of-the-art $500,000 CAD/CAM system. We financed this with 10 percent investment tax credit, which put $50,000 cash in, we got a 5 percent reduction in interest rate because of safe harbors loans, and prior to that we had bought a brand new building that we financed with industrial revenue bonds that got the interest rate down to 60 percent of what was being charged or whatever in those days. Those programs are all gone.

Certainly, you can encourage those kinds of loans to be made with Federal tax policy. I repaid the loan on my CAD/CAM because it was a good investment, although it was an interesting one, borrowing twice my net worth on a piece of equipment that was not worth half of what I paid for it on the day that I moved it in, because there was no market for a state-of-the-art CAD/CAM system. It helped us to survive.

The final point I will make in regard to your last point pertaining to loans for the minority community. The White House Conference called for some speedy action on enforcing CRA, which is "Community Reinvestment Act."

I think the House of Representatives has already passed some legislation. I do not know whether it has been enacted into law or not. I think by encouraging the banks who invest in core central cities by making that a part of how they are being judged, I think you can loosen up some additional monies for the minority community.

I certainly agree with you that the funds available for startups are, as I said, virtually nonexistent. I will make the additional

point that I need to separate myself from other small business people I am in manufacturing.

Today, to buy the first machine that you need to startup a small machine shop is likely to cost you $100,000 or $150,000. This you are not going to finance out of your MasterCard or your Visa. You need to have the banks or somebody there who is going to lend you that money without having to come up with a 50 percent or 80 percent on those machines.

Chair MEYERS. Thank you.

Ms. KIRKPATRICK. Could I make just a real quick comment. After 1986 the redevelopment in the areas when there was no tax credits available in the area of the North St. Louis community stopped. I think that CRA is an enforcement process, and I have served on a CRA Committee.

What I think really happens there is that, number one, you have to regulate it; you have to examine for it; you have to spend a lot of money enforcing it. Number two, the banks then have to turn around and spend a lot of money documenting, it ends up.

In my estimation, I saw a lot more documentation and regulations activity than I saw actual lending activity. I believe incentives are the answer. I believe that if a person wants to invest in North St. Louis — like one of my clients whose loan I guaranteed, whose loan I am now paying — if they want to invest in repairing and rehabbing a building, why in the world would not the city of St. Louis want to find some kind of tax incentives?

That person is going to turn around and pay taxes that are worth much more. I think part of the answer is obviously tax incentives. It is not more regulation — it is absolutely not more regulation.

Chair MEYERS. Thank you very much.

Mr. Chrysler?

Mr. CHRYSLER. Thank you, Madam Chairman.

Being only one of four people in the Congress with a manufacturing background, this is a subject that is near and dear to my heart certainly. Loans that banks make in the beginning certainly are the way that banks make their money. That is when you are borrowing most of the money, that is when you are paying most of the interest.

Five, 7, or 10 years into your business, you are pretty much working on your own working capital. I think it is a great place for banks to be and be into a business early, because that is where they are going to make most of their money.

I guess I would ask the question: Will the banks ever get into the business again of making business loans as they used to as long as the Government is in this business? With things like loan guarantees and things like that, they just kind of take the banks off the hook for these kinds of loans and put the Government on the hook for them.

Will the banks ever really step up to the plate again as long as they know they can kind of get Uncle Sam to be on the hook for these things?

Chair MEYERS. Mr. Gerber, and then I think Mr. Dennis wants to comment also.

Mr. GERBER. Personally, I think that the banks can come back in. I think what we have learned in Connecticut is that excessive regulation can drive them out, but I do not think they are either stupid or incapable of knowing what their business is.

I think, as somebody has already said, that they have been driven out by regulation. I think that in time they will come back and provide some expression of the total capitalization of small business. However, they will have had to make room for some other nonbank banks, and that sector will also have a part of the final lending picture.

As far as whether Government competes with banks, I can remember the times when bankers would say, "Well, we could get this thing guaranteed by the SBA, but it is so much trouble, let us not bother." They coexisted with Government guarantees back in those days.

I think that small business people would probably prefer not to have the red tape and the extra oversight of a Government guarantee, if they could get it. These days you cannot get it, so everybody is using the SBA, which is proper.

They were set up originally back in the fifties in order to provide capital to a sector of the economy which was first being recognized as unique and which was underfunded. They are performing their function when they get more and more business.

Mr. DENNIS. One phrase we have not used today is "savings and loan crisis." Because of that I think things will never be the same. It clearly had a major impact on the way we do things in this country, and should have. That is the first remark I will make. Second, you asked the $64,000 question with regard to SBA lending. I have noticed among our population that bankers are much more enthusiastic about SBA guarantees than are business owners.

Chair MEYERS. I beg your pardon, could you repeat that, please?

Mr. DENNIS. Yes. Bankers are much more enthusiastic about SBA guarantees than are business owners. Now, I am not sure what to make of that. I mean, are we sitting in a situation where the banks are saying, "I cannot make the loan unless," and the business owner does not see that? Or is it just a very, very profitable opportunity for banks which say, "Hey, I cannot turn that down"? Or are we using guarantees to perhaps lower interest rates for the borrower, and is that the purpose of it?

There are a lot of very reasonable questions that need to be addressed. As I mentioned earlier in my testimony, there are clearly gaps that need to be filled, and that is the other issue. Are the SBA programs or SBA loans filling those gaps, or are they going to general areas where credit might otherwise be available? I do not have any answers for you.

Mr. CHRYSLER. I have been putting together a small business bill of rights and obviously this is number one on the agenda there. I guess my question is: What can Congress do to get out of the way? How do we solve the number one problem in prohibiting small businesses from startup or expansion? What suggestions do you have for me?

Ms. KIRKPATRICK. Certainly, one of the things is to privatize the SBIC and allow them to securitize small loans. I mean, all of us

understand the balancing the risk in a portfolio, so that would allow that to be done. What that means is that is now private.

Chair MEYERS. May I ask a question, just to clarify my own thinking?

Ms. KIRKPATRICK. Sure.

Chair MEYERS. Right now, the SBA stands in back of an SBIC loan. You are saying that we should make a GSE out of it, where we would stand in back of an SBIC loan. What is the difference?

Ms. KIRKPATRICK. Well, I think the difference is in encouraging private investors to invest their money in it as well, so that there is more capital available. Maybe it is a matter of expanding capital more than it is changing the structure.

I mean, NAWBO looked at establishing an SBIC for our members, and it is just too much red tape. It is just too complicated. If we could get private funds to support a kind of capital formation and allow other people to invest, I would invest in that kind of fund. As it is, I personally have invested in helping people get money. I have also lost a lot of money that way.

I think that being able to invest a certain amount of money in a fund that would loan to small businesses, and also it would be a lower amount. The SBIC's that I know in St. Louis do not make anything under a $1 million loan, so that would be a difference as well.

Chair MEYERS. That is interesting.

Mr. CHRYSLER. Would you think on the LowDoc end of this? I think the LowDoc is $100,000 loan. In the manufacturing industry, you do not get much for $100,000.

Ms. KIRKPATRICK. Right.

Mr. CHRYSLER. Do you think expanding the LowDoc Program to, say, $1 million rather than $100,000 — maybe $500,000? I am thinking once you are on the hook for $100,000, if you are in that category, that is all you need, I mean, another——

Ms. KIRKPATRICK. A lot of service industries — see, a lot of women-owned businesses are in the service industries, and there is not a lot of capital. I understand because I am on the board of a steel manufacturing company, so I understand the difference in the capital needs.

The LowDoc loan really met a need that was not being met because it was a smaller amount of money. Banks do not want to make those small loans, because it costs as much to make a $50,000 loan as it does a $500,000 loan. It may not be as risky, but it costs as much to actually do all the transaction process.

Mr. CHRYSLER. It simplifies the paperwork, obviously, the LowDoc.

Ms. KIRKPATRICK. The LowDoc did simplify, right. It was a great program.

Mr. CHRYSLER. Why would you not want to do that for, say, a $500,000 or even a $1 million loan, simplify the paperwork, because obviously if you have got enough information on two sides of one page to loan somebody $100,000, you ought to have enough information there to loan them $1 million.

Ms. KIRKPATRICK. Well, I think that is possible. However, I would not want to eliminate the possibility of the smaller loan. That was my point.

Mr. CHRYSLER. No. I would not want to, either. I am not saying eliminate that. I am just saying that the number should be increased, so that we could do a little bit more.

Ms. KIRKPATRICK. In our area, the LowDoc Program was extremely helpful, and was used to a great extent.

Mr. CHRYSLER. I guess the other thing is, how do we create competition to banks to fill these capital pool needs? I know certainly balancing this budget, bringing the interest rates down is going to be a big help to make everything less expensive from cars to business expansion to student loans, et cetera.

I think as we move toward a balanced budget and then start to eliminate the debt, I think we leave the banks in a very precarious position. All of a sudden they have $5 trillion that they do not have their number one best customer to loan it to anymore, and they have got to find other customers.

I think that is what presents us with the opportunity at least of saying, "Okay, Mr. Banker, what are you going to do with the $5 trillion? Here are some people who are out there that need it." We have got to find ways to make that transition and to make that available.

Ms. KIRKPATRICK. Well, if, for example, a Vicky Mae or an SBIC privatize would be made available to banks to put a few million into maybe income tax free or something, I think they would do that.

Mr. DENNIS. First of all, you have a number of new competitors in the market, and you do not want to injure them. I mean, we do not want to be in a situation where we are going to try to do something to make it more flexible for banks, then turn around and injure leasing companies, financing companies, and that sort of thing.

I mean, it is very important to recognize these new institutions are lenders and are providing enormous sources of capital right now and are a major competitor for banks. In a good sense, they are making banks really look at the small business market.

Mr. CHRYSLER. Is there anything we can do to help that?

Mr. DENNIS. Well, no, I do not think there is anything you can do right now to help it. I think you can equalize the rules between them to a greater extent. If you are going to do that, make sure that you the rules of the banks more toward the finance companies and those types of institutions rather than the other way around. I mean, you can do that.

Mr. CHRYSLER. Well, one of the things just in that area. Seventy-five percent of the money in this country now in lending institutions are in something other than banks; 25 percent is only in banks.

Of course, we have 40,000 regulators on banks, which goes back to the issue of the overregulated industry, and we have 600 regulators on the other 75 percent of the dollars. The reason for that is because we, as a Government, have this thing called FDIC; we guarantee loans. We say as long as we are going to guarantee——

Chair MEYERS. We guarantee deposits.

Mr. CHRYSLER. We guarantee deposits. As long as we are going to guarantee the deposits, then the Government is saying, "Well, then we have got to have these 40,000 regulators in there looking over this money."

If we just privatize the FDIC and said, let them go out and buy insurance to cover their deposits — quite frankly, I think you need to insure loans more than you need to insure deposits — but if they want the little old lady that has got some money, her last $20,000 or the like, if she wants it insured, she ought to be able to buy private insurance and insure it.

It would be cheaper. We could get rid of maybe 39,400 regulators in the banking industry, and maybe we could free up this industry to make the kinds of loans that we are talking about here today.

Chair MEYERS. Thank you, Mr. Chrysler.

Mr. Flake?

Mr. FLAKE. Thank you very much. Madam Chairman, I think this is a very worthwhile hearing that you are holding today, as a member both of Small Business and the Banking Committee.

I think it is more interesting because we have struggled, over this last 10 years of my being on the Banking Committee, with some of these issues, some of them having to do with, perhaps, repeal of Glass-Steagle and having lived through the whole FIRREA adjustments and actually doing some portions of that legislation.

There is a reality that we do have a major problem in terms of just banks are making money. There is no doubt about it. The question is: How do you get that money into the hands of the people who need it the most? I think it is most needed in the small business sector.

Our level of competitiveness can not be really what it ought be with other companies around the world simply because of the fact that it is cheaper to produce and to manufacture there.

A lot of it really has to do with the fact that we are not doing as good a job as we should in terms of making loans available in many underserved places.

I had a discussion with the Speaker of the House, Newt Gingrich. One of the things we talked about was the fact that if you are going to talk about building the America that everybody dreams about, you cannot do that and leave behind a certain amount of the major communities of this country.

I mean, America's strength lies in its urban communities, which, for the most part, are blighted, and do not have access to capital, nor do they have the means to rebuild.

I think all of us really have to be very clear that Government still has a role. The question is, How much of a role? I think all of us would agree that we do not want overregulation, but I think we all agree that SBA represents the best hope for the moment of getting money into a lot of entities, and that is not just African-American or female but the entire small business industry.

The banks have an idea that they would rather take the risk knowing that they have a guarantee than not take the risk at all.

That may be part of the answer to your question, Mr. Dennis. I do not think they lower the interest rates. I honestly believe there is a longer timetable because they are waiting for SBA to make its approvals. That has gotten to be more difficult over the last year or so.

I think the bottom line for them is, "If I am going to make this loan that I have, can make sure that I am able to justify the

amount of loans in this portfolio to my stockholders, and SBA gives me an opportunity to provide that kind of guarantee."

I think LowDocking obviously is a two-edged sword. It has its pluses and it has its minuses. In some places where banks over did it, they took a major beating, which was part of the problem we faced in the S&L crisis.

I think that the question that I ask really is, what is in our best interest? To follow up Mr. Chrysler's question, what do you think best meets the needs of the small business community, while at the same time addresses the major concern of the banking community, particularly in light of the fact that what FIRREA did was move a major player in the small business sector?

What FIRREA did was restrict the amount of money available for loans through the S&L's which, for the most part, are the institutions that are still located in the communities where commercial banks have left.

They were making the kinds of loans that are not being made in many instances now because we do not want to put them at risk again. That obviously will not reverse itself. It is not politically palatable for those of us who served on the Committee. The reality is we have got to find a way.

The nonbank banks are moving in: GCC, General Electric, Beneficial, Household. All of them are there, and they are working overtime. As a matter of fact, they do not shut their offices at 3 in the afternoon.

When I spoke to a banker group down in West Virginia, I said, "One of the problems is you have got to get off the platform, get out in the community, and find ways the make the loans." These guys are out there. I closed my mortgage loan at 9 p.m., at my dinner table with General Motors Acceptance. I mean, everybody is doing it differently.

The question becomes, how do we best fill that need, while at the same time providing protection and guarantees that the Government and that the banks need, and at the same time protecting the U.S. taxpayer with the assurance that if we do not build this sector, we are going to continue to lose our competitiveness? Anybody can take it on. I do not know whether it is a question or a comment.

Chair MEYERS. Well, Mr. Gerber, do you want to start?

Mr. GERBER. I do not mean to dominate the answers, but I am just so thoroughly prepared on this.

Mr. FLAKE. Well, answer, that is okay.

Mr. GERBER. Thank you for opening that door, Congressman Flake. With regard to competitiveness, I want to make the point that in the last 10 years, American manufacturing has become the best in the world. We are the most productive, the lowest cost producer, and producing the highest quality products in the world. This is a distinct change in a 15-year period.

I would like to also make the point, in agreement with what you said, that the percentage of loans that banks have out for small businesses — I have two documents here, one says that 10 percent of banking portfolios are loaned out to small business, the other one says 20 percent. In either case, it is far too little a portion of

their total loan portfolios to provide to a sector that is 45 or 50 percent of the gross domestic product.

Why do the banks like SBA? This is one of the places where you can learn something about the situation by studying a desperate place like Connecticut. The banks like the SBA because, first of all, when there is a guarantee of the loan, that loan no longer can be held against their cash reserves. It is a guaranteed cash reserve, and the bank is not going to get into trouble with the regulators.

They also bundle SBA loans and sell them in a secondary market. They get their cash back in. They make a small percentage of what they have sold, and they have got the money to use over again. They have their cake, and they are able to eat it too. It is a very good deal for the banks. They should like SBA loan guarantees.

To answer your question about what best meets the needs of the small business community with regard to getting the banks to loosen up and to perform their function in our economy, I think it is a relatively simply answer that is probably hard to implement; and that is, get the regulators off the backs of the banks. They are not stupid. They are not unwilling to do it.

They did their thing back in the eighties. Maybe a little too aggressively, but Congress was partially responsible for that, for going from $40,000 to $100,000 guarantee and then deregulating the banks at the same time. Yes, you got some very aggressive actions on there.

Chair MEYERS. Would the gentleman yield?

Mr. FLAKE. Yes, Madam Chair.

Chair MEYERS. I would like to pursue that for just a minute. When we talk about the regulators, I guess we are really talking about Congress, are we not?

Mr. GERBER. No. There are two, Madam Chairman, one is administrative and one is congressional.

Chair MEYERS. All right. But the bank reserve requirements, for instance, those are congressional? Those are in law, are they not?

Mr. GERBER. Yes.

Chair MEYERS. Then the regulations that impose classification requirements — what is a "performing loan," what is a "nonperforming loan" — are they in the law or is that administrative?

Ms. KIRKPATRICK. Well, it is even more complicated because there is State chartered and nationally chartered banks.

Chair MEYERS. Sure.

Ms. KIRKPATRICK. In some instances, where the FDIC is obviously examining banks that are State chartered, they are less strict, in some instances, than State regulators. There is not very much consistency here.

There is a dual system: There is the Federal Reserve that comes in and examines holding companies and there is FDIC and then there are State regulators. That is what makes it so difficult and so complicated. In some instances, you follow the advice, seriously, of the FDIC and they tell you what to do, then the State examiners come in and do something different.

Mr. FLAKE. Layers of revenue.

Chair MEYERS. The point I was trying to get at is the third thing, the usury laws, which prevent you from exceeding certain interest amounts.

Ms. KIRKPATRICK. Yes. For individual.

Chair MEYERS. That is usually set by the State, is it not?

Ms. KIRKPATRICK. Yes.

Chair MEYERS. For both Federal and State banks? I mean, the usury laws are set in State legislatures.

Mr. DENNIS. In Arkansas, they are in the Constitution.

Chair MEYERS. That is interesting. A little harder to change that one.

Chair MEYERS. I guess my question is: When we start talking about the regulations, which are too tight, which do not allow banks to make loans, are we talking about easing the reserve requirements?

Do we want to ease those classification requirements as to what is a good and what is a bad loan? Do we want to supersede the States and change those interest rates?

I hear all the time about the regulatory climate in banks, and that that is responsible. I have never asked the question, what do you want to change? Maybe if you do not mind, and then we will go back to your questions.

Mr. FLAKE. Yes. If you will yield back? One of the things, from the Banking Committee is that interest is not a primary issue here. The issue becomes the layers of regulators with different interpretations of the law.

What my impression is, is that you have a case where State regulators could require one thing, Federal regulators can require another thing. You are not always just dealing with FDIC. There are other times you have the overlap with thrift supervision, and you have all of the others as well.

I mean, really what happens, nobody wants to give over full responsibility to any other entity. The Fed is saying one thing, the FDIC is saying another thing, OCC is saying another thing, Office of Thrift Supervision is saying another thing.

All of that, in many ways, compounded by the fact that the State regulator may be saying something altogether different. Depending upon the role of the bank and what functions it is performing, you can actually have three or four different regulating bodies saying three or four different things. I may be wrong, but I think most people would agree.

Ms. KIRKPATRICK. That is absolutely right.

Chair MEYERS. That is very strange.

Mr. FLAKE. It is.

Chair MEYERS. Very strange.

Mr. FLAKE. I may say this because I was on the Committee to redesign with Doug Barnard, when he was a Member of Congress here, we were going to restructure the whole banking industry, try to come under one regulator. That was 8 years ago. We did the same thing 2 years ago.

The reality is there is not a will on the part, particularly of the Fed, to be a participant in that kind of restructuring and that kind of change. As strange as it is, you are dealing with four elephants, all of whom think that they have a right to do what they are doing.

Chair MEYERS. Well, at least they are elephants.

Mr. FLAKE. Yes. That is why it is messed up.

Ms. KIRKPATRICK. Could I make a kind of a constructive comment?

When the OCC came up with the concept of a basket of loans, these loans could be made to small businesses and they would be character loans and they would not require all of the documentation and all of the collateralization. I mean, if you see a loan file, you see something this [indicating] thick; you do not see something this thick.

The "basket of loans," by definition was that these loans would be a basket, and the bank would say, "We are going to have this basket of small loans." Most of them were small business loans. The problem with it was that it was based on the asset size of the bank, so that for some banks it would have been one loan in the basket.

I mean, the concept was of taking this groups of loans that could be called "character loans" and putting them in a basket, and those could be looked at as a whole. However, the amount of that basket was restricted so severely that it had no meaning at all. It absolutely had no meaning.

The concept is still a good concept. They would continue to look at big loans. Banks need regulators to look at big loans because you need the make sure that you do not have inside people who are trying to — fraud was one of the issues in savings and loans; it was not just making bad loans.

Mr. FLAKE. Absolutely.

Ms. KIRKPATRICK. You need them. You need to be able to take a group of loans in the community where your bank is involved. They could be character loans. They could be in the part of town that needs redevelopment. They could be a lot of things, but they would not be looked at individually and scrutinized and classified as bad loans. If you are a publicly held bank and you have ended up in the newspaper with a bunch of criticized bad loans, you are in a heap of trouble.

Chair MEYERS. I understand.

Mr. Smith?

Mr. SMITH. Madam Chair, I started my testimony by talking about the New England experience in the late 1980's. I knew that very well because we were an investor in the Bank of New England on behalf of our clients.

Our understanding of the situation there is the regulators at the administration level changed the rules of what was a nonperforming loan midstream; that created shock waves throughout the country. All banks when the auditors were coming were communicating very aggressively about what the documentation that was now necessary to satisfy the regulators.

As a result of that, there was a culture of just more and more regulation and more and more documentation by the banks. When you ask banks to make character loans, generally speaking, for a small business loan officer, it is a career-threatening decision. It just is a very frustrating situation.

Chair MEYERS. Mr. Gerber?

Mr. GERBER. Much of what she said is true. The regulations may be in law, may even be constitutional, but the fact is how you get to the point of making a classified loan is still a function of the practice.

For example, why should a loan which is current, which has been paid down on a steady basis from a company that has a continuing business get classified because the local real estate market has dropped the value of the real estate below what the regulators and what the bank wants to secure the loan? It is current. The cashflow is there.

I do not think that kind of thing exists anymore that says you must classify a loan because the value of the real estate has dropped. That is a bureaucratic thing.

I have an article here from an economist named Elliott Janeway that I would like to make available to you as well. He speaks here about the Fed and the Treasury having instructed the examiners to ease the rules, or they could have. Alternatively, they could have improvised temporary accommodations for banks that were getting into trouble.

The point is that they went the opposite direction in New England in the early nineties, and they did not have to. I am not sure I can tell you what needs to be done from a regulatory standpoint, but I know at one time it was better than it is now. We ought to be able to go back to more accommodating practices.

Mr. FLAKE. Well, if you will, the problem is not so much in terms of not knowing what needs to be done in that regard. The issue is that the S&L debacle became such a major political hot potato that in this Congress now you could never pass regulations or laws that would, in effect, solve these problems because everybody has a different political perspective and they do not want to be the one responsible for doing what was done before when you deregulated.

You did not know what was going to happen in the industry. A lot of people came into the industry who had no banking background. Once that door was opened, you know what the problems were, everybody was so afraid that the problem would come back; or, two, that the taxpayers are going to be on the line.

This has become such a real political issue that nobody really wants to do what I consider to be in the best interest of the country as it relates to its ability to compete.

It always falls into the political category. In this place, the political winds pretty much determine which direction you go. It really makes for some bad legislation. That is the bottom line. It does not matter whether the Republicans or Democrats are in charge, I have said this all along.

Chair MEYERS. Thank you, Mr. Flake.

Mr. FLAKE. I mean that.

Chair MEYERS. Your questions are important ones, and I appreciate it very much.

Mr. FLAKE. Thank you, Mrs. Meyers. I apologize for leaving. I have a Banking Committee meeting.

Chair MEYERS. Did you want to comment, Mr. Dennis, on that last question or the last comment?

Mr. DENNIS. Well, no, I guess I want to repeat what we said before, and that is, things will never be the same. The S&L situation

provided a seminal event which will always, at least in our lifetimes, influence what is happening in the banking community. I do not think that we can ignore that. We have to work around it, with it, and that kind of thing. You cannot ignore it, because it has changed everything permanently.

Chair MEYERS. Thank you.

Mr. Gerber?

Mr. GERBER. Historically, the S&L situation occurred after banking deregulation was passed in 1986. I think there was probably a transition period during which people were trying to figure out how to operate in such a milieu. We are now 10 years downstream of that, and I think that a lot more realism has come into the banking business.

Chair MEYERS. I am going to ask a couple of questions to kind of refocus on the private sector, and then I will let you all go. I just think this has been a really outstanding hearing, and I appreciate it very much.

Let me ask whether any of you have any experience with a strategic partnering? These arrangements between small businesses and large corporations really serve a dual benefit. The large corporation cements its relationship with small business suppliers; the small business receives benefits through financial resources, management assistance and access to distribution channels.

Some recent studies have shown that more than half of the Fortune 500 companies have strategic partners. I was not aware that this was going on to that extent. It evidently is serving as a source of capital to small businesses. I just wondered if any of you had any comments to make about that or any experience with it?

Mr. SMITH. No.

Chair MEYERS. I think one of the reasons we are looking at this, of course, is if we are on a path to a balanced budget by 2002, and I do believe that we are, there is not going to be a lot of new money available in the SBA. In fact, we are going to have to tighten up.

I am a supporter of the 7(a) Program and the CDC Program. I am even a supporter of the SBIC Program, although I do think we need to make some changes in that program. I have some questions about the LowDoc Program, however.

I have heard from some bankers who have said to me that they think the LowDoc Program may be an accident waiting to happen. I want to make sure that that does not happen because I think that the program is of benefit — it is a good tool.

We had not ought to get sloppy with the LowDoc Program and let the loss rate get so high that we have a problem in the SBA. We have now lowered the amount that we guarantee with respect to small-business loans to 80 percent for the smaller loans, under $100,000, and 75 percent for loans over $100,000.

The bankers seem to realize that these changes in the guarantee rate were necessary because there is less money that is going to be available. Of course, while they would like us to guarantee 100 percent, we did not hear a lot of objection from the banking community on this, and it does not seem to have hurt the amount of loans that they are willing to make.

That being said, let me ask, Mr. Dennis, other than "angel investors," how else can small businesses increase their equity capital?

Mr. DENNIS. If I may, I would like to rephrase your question, because I do not think you can say "other than 'angel investors.'" It seems to me that that is the source, the major source, of equity capital you are going to have unless you do something like change the banking laws enormously allowing them to invest. That would be an absolute revolution in this country. They can do it other places in the world.

I think "angel capital," institutional venture capital, is not particularly geared for the type of business that we are talking about for the most part here. It is focused on a very, very narrow set of specific firms. Allowing firms to go public, for example, is another potential.

But again, that affects very, very, very few firms. It is not that it is not important to those particular firms involved, it is. Certainly there are some things that would allow more to do it. There are apparently some things that are being considered over in the Banking Committee now that might do that.

As a general rule, I think that your focus, the appropriate focus, would be on "angel capital" and how matches could be made more easily; to what extent does State regulation prohibit the interstate movement of capital, that is necessary; and that kind of thing.

Again, let me urge you to contact Professor Wetzel. He is really not only an academic who stands in front of the classroom and writes articles, he is a fellow who actually does it.

Chair MEYERS. This is the gentleman from New Hampshire?

Mr. DENNIS. The University of New Hampshire, yes.

Chair MEYERS. All right.

Mr. DENNIS. He is terrific.

Chair MEYERS. Well, I appreciate that very much, and I am sure that we will be in touch with him.

Let me ask Mr. Gerber a question. You mentioned three Federal tax programs, the IRB's, the investment tax credit, and one other?

Mr. GERBER. Accelerated depreciation and also safe harbors, Madam Chairman.

Chair MEYERS. Yes.

Mr. GERBER. All of which were programs.

Chair MEYERS. However, let me ask you this. It seems like everything has both an upside and a downside. People have said to me, "You really ought to enact capital gains." I have been a very strong supporter of special treatment for capital gains, like small business generally.

They said when you have very generous capital gains provisions and investment tax credit provisions and accelerated depreciation all at the same time, then that leads to the kind of explosive economic growth, that we had in the early 1980's, which some have argued culminated in a strong feeling of tax rebellion.

In the mid-1980's when I came to Congress, people were saying to me, "I am a small business person. If I am paying $1,000 in corporate taxes, do not you think General Electric ought to be paying something?" It had led to the fact that very large firms were paying no Federal taxes, and small business people were paying a substantial amount because they could take advantage of the benefits of capital gains, accelerated depreciation, and investment tax credit.

While not the only factor, this kind of tax disparity in many ways led to the 1986 Tax Act.

Now we want to make sure that we do not get to that state again. While this may be difficult right off the top of your head, I would appreciate your thoughts on this issue and whether you see any middle ground for us to strike.

As I say, I strongly support capital gains, and I thought that investment tax credit and accelerated depreciation were good things. Evidently, however, all of these benefits at once can lead to a bad end.

Mr. Gerber?

Mr. GERBER. Thank you for breaking that topic. For one thing, you have acknowledged the NAM position, where we believe that 3 percent, 3¼ percent, maybe even 3½ percent growth of the economy is completely possible without regenerating inflation and will do more to reduce the deficit and provide for the needs of people than any other program that you might conceive of.

The issue of where to go to find a medium, in between, place between the extremes of the 80's and the extremes of the 90's, I would suggest — and I will not get any complaint from this panel — my proposal is to cap things and to recognize the size of these kinds of benefits that small business needs. You provide $500,000 worth of depreciation a year, and it does not mean a darn thing to General Motors, but it means a great deal to Murray Gerber.

Chair MEYERS. Yes.

Mr. Dennis?

Mr. DENNIS. You always have a lot of competing interests, as you well know. Clearly, there are competing positions between arguments of economic efficiency and fairness, and they are not always the same position.

You have competing arguments between manufacturers and service industry that need different things. I think Mr. Gerber is absolutely correct when he is talking about the kinds of things that stimulate his business. On the other hand, talk to a service businesses. They are going to be more interested in what we are going to do about payroll taxes.

There are always these competing interests, and I do not think there is any magic bullets. They are what we say they are. They are competing influences, and you have to do the best you can to find a balance. Whatever balance you decide or someone else decides is not going to make everybody happy.

Chair MEYERS. Well, I would appreciate it if you would think about any innovative solutions. I think your testimony was very valuable today about sources of capital for small business because we do need to grow at a little faster rate than we are growing now.

I think that the only way we are going to do that, if the statistics I read are correct about the number of jobs that small business generates, is by finding more sources of capital for small business. Government can be of some assistance. Because it is a unique niche, I think it is appropriate for us to have a role. The bulk of the solution however, is going to have to come from the private sector.

A great many small business people have said to me, "If we want a small, short-term loan, we can go to the bank and get it. It is

when we need a larger loan which we repay over 5 or 10 years, that we cannot get it." The latter is the kind of financing that we are going to need in order to grow these businesses.

I am a strong supporter of the 7(a) loans, at least at this point in time, but we have got to look at other innovative ways to respond to the capital needs of small businesses.

I appreciate your being here today, and I appreciate your views and insights. Anything you would like to submit in writing, any thoughts that you have later on this, I would also appreciate. We are going to have a series of hearings specifically on bank lending and venture capital as sources of financing, security offerings and regulations — which some of you have said that is full of cost and red tape — and institutional investors as an untapped source of capital. Any thoughts that you have we would appreciate. I thank you very much for being here today.

We are adjourned.

[Whereupon, at 12:05 p.m., the Committee was adjourned.]

APPENDIX

STATEMENT OF FLOYD H. FLAKE BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

FEBRUARY 28, 1996

I THANK YOU, MADAME CHAIRWOMAN MEYERS, FOR CONVENING THIS HEARING TODAY ON SMALL BUSINESS' ACCESS TO CAPITAL. AS I AM SURE YOU ARE WELL AWARE, INSURING THAT SMALL BUSINESSES HAVE ACCESS TO CAPITAL IS AN ISSUE WHICH IS LINKED TO THE STRENGTH OF THE UNITED STATES ECONOMY. IN FACT, SMALL BUSINESSES EMPLOY ABOUT 54% OF THE PRIVATE WORK FORCE, CREATE TWO OUT OF EVERY THREE NEW JOBS AND PRODUCE TWO AND ONE-HALF AS MANY INNOVATIONS PER EMPLOYEE AS DO LARGE FIRMS.

IN THE PAST, COMMERCIAL BANKS HAVE PLAYED A MAJOR ROLE IN PROVIDING CAPITAL TO SMALL BUSINESSES. IT IS OUR ROLE TO CONGRATULATE THOSE BANKS WHICH ARE CURRENTLY PROVIDING SMALL BUSINESSES WITH THE FINANCIAL MEANS TO PROSPER. IT IS ALSO IMPORTANT FOR US TO EXPLORE WAYS TO ENCOURAGE THOSE BANKS WHICH ARE NOT TRADITIONAL SMALL BUSINESS LENDERS TO TAKE ADVANTAGE OF A POTENTIALLY PROFITABLE LENDING MARKET. IT HAS BEEN PROVEN THAT BANKS WHICH HAVE

INVESTED SIGNIFICANTLY IN SMALL BUSINESSES TEND TO BE MORE PROFITABLE THAN THOSE WHICH MAKE FEW SMALL LOANS. I THINK THIS IS DUE, IN LARGE MEASURE, TO THE EXTENT TO WHICH THESE INSTITUTIONS HAVE ADAPTED THEIR LENDING PROGRAMS TO ADDRESS A SMALL BUSINESS' UNIQUE NEEDS.

IF WE WANT TO SINCERELY INSURE THAT OUR ECONOMY BENEFITS FROM THE JOB CREATION, INNOVATION AND EFFICIENCY THAT THRIVING SMALL BUSINESSES PROVIDE, WE MUST DEMAND THAT THEY HAVE THE APPROPRIATE ACCESS TO CAPITAL FROM NOT ONLY BANKS, BUT ALSO ALTERNATE FUNDING SOURCES AS WELL. WE ARE FORTUNATE TO HAVE SEVERAL EXPERT WITNESSES HERE TODAY WHO CAN GIVE A FIRST-HAND ACCOUNT OF SMALL BUSINESS NEEDS. I LOOK FORWARD TO HEARING TESTIMONY ON WAYS TO INCREASE COMMERCIAL BANK LENDING TO SMALL BUSINESSES AND UTILIZE NEW SMALL BUSINESS FUNDING SOURCES.

Opening Statement

of

Hon. John J. LaFalce

February 28, 1996

At the outset, I want to compliment Mrs. Meyers for commencing this series of hearings on Small Business' Access to Capital.

Most Members of the Committee are knowledgeable about the financial assistance programs made available through the Small Business Administration: primarily the 7(a) loan guarantee program, the 504 or Certified Development Company program, and venture capital provided through Small Business Investment Companies.

Many Members do not realize how little capital would be made available to the small business community if these SBA administered programs were either withdrawn or made effectively unavailable by the imposition of excessive fees either on the borrower or the lender who provides the money.

The Government does not have the resources to fully satisfy the financial needs of the nation's small businesses. Nor should we attempt to develop them. However, it is appropriate and necessary that the government supplement the efforts of the private sector, whether that be to fulfill a particular government policy goal or to provide assistance during a firm's infancy while it is developing a sufficient track record to warrant lending by the private sector without any government enhancement.

We in Congress are confronted with the necessity to reduce Government spending. As we make these choices, we can no longer claim that we are eliminating poor or ineffective programs - - - at

least we can no longer claim that we are simply tightening up poorly designed or run programs at the Small Business Administration. We eliminated or cut back unwarranted spending at SBA many years ago.

Last year we increased the cost of participating in SBA loan programs. We imposed higher fees both on participating lenders and borrowers. I do not believe that we can wring more money from either source.

But some will undoubtedly urge us to do so. To rebut these admonitions, I believe it is imperative that we develop current information on exactly what is available through the private sector.

The Committee did this in the past, and hearings on capital access which were conducted by the subcommittee I was privileged to chair were very informative and beneficial.

Some things have undoubtedly changed since then, but I believe that we will find that some things never change. One of those things that never seem to change is that those with capital - - - whether they be banks, savings and loans, non-bank lenders, insurance companies, pension funds, or whatever - - - have little interest in making loan capital available to the small business community. Greater profits can be made on financing larger firms. And this is where the private sector will put its money. SBA and its programs address a continuing need.

This is a critical topic which must be explored, especially for the benefit of my newer colleagues, and I look forward to today's testimony.

STATEMENT OF
REP. JAN MEYERS (R-KANSAS)
CHAIR
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

February 28. 1996

"Small Business' Access to Capital: Impediments and Options"

Good Morning.

Our hearing this morning is the first in a series that this Committee will hold over the next few months on small business' access to capital In this morning's hearing, we will endeavor to identify "the problem" -- that is, what are the current conditions and availability of capital for small businesses and what are the specific obstacles and opportunities that small businessmen and women face in this area? Once we have clearly defined the problem, the Committee will explore, in future hearings, specific capitalization options such as bank lending and venture capital.

Let me also say at the outset, that this series of hearings will focus on sources of capital available through the private sector While there are numerous Federal government programs designed to facilitate small businesses in meeting their capital needs, these programs cannot and should not be the sole source of financing for small businesses Moreover, the American people, and especially small businessmen and women, have made it clear that government should be smaller, less burdensome, and less intrusive. Therefore, I believe it is important for us at this juncture to explore ways that the private sector can marshall its resources and innovative talents to meet a greater part of the capital needs of this country's small businesses

This issue is also not just important to small business, it is critical for the country as a whole. For instance, in 1994 small businesses accounted for 99.7% of the nation's employers, employed 54% of the private workforce, contributed 52% of all sales in the United States, were responsible for 50% of the private gross domestic product, and produced an estimated 62% of the new jobs in that year. These are extremely impressive statistics, which could never have been achieved without capital In addition, given the fact that capital access is often the toughest for small firms, it is extraordinary that these businesses are able to accomplish so much with so little.

Historically, men and women seeking to start a small business have relied on their personal savings and individual credit to get the business off the ground As the business grew, the owners reinvested their earnings, utilized trade credit, and looked to bank loans as financing for expansion In recent years, however, the level of bank lending to small businesses has

declined, in large part because of stricter bank regulations and increased paperwork burdens and compliance costs As a result, small businesses have increasingly had to turn to other sources in the private sector to finance future growth and development. In this context, it is not surprising that the delegates to the 1995 White House Conference on Small Business made capital formation one of their top priorities.

This morning we will hear from six witnesses representing individual small businesses as well as small-business organizations. I have asked the witnesses to provide the Committee with their insights as to the current and historic private-sector sources of capital available to small business and the specific obstacles and opportunities that exist in these areas

It is my hope that this hearing, and the follow-on hearings in the series, will accomplish two tasks. First, identify some of the regulatory impediments, which if remedied, would allow the private sector to provide better capital access for small business. And second, open a forum for new ideas in order to stimulate the innovative genius of the private sector and develop new alternatives that will enable small businesses to continue their invaluable contribution to our national and local economies.

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

February 28, 1996

Testimony of Representative Glenn Poshard

Madame Chairman, thank you for holding this hearing on the status of small business' access to private sources of capital. Recent statistics regarding bank lending, the leading source of small business capital, are mixed for those planning new enterprises or maintaining established entities. As this traditional source of financing is less available in some locales, it is imperative to map out the landscape of private capital sources.

This is an especially intriguing topic for it encompasses many of the subjects this committee has examined over the past year, including banking regulation and increased paperwork burdens, while incorporating developing trends in small business financing. As I have stated on other occasions before this body, our job is to help provide an environment in which small businesses can reach their full potential. Helping them identify these private options as well as the potential pitfalls involved should help small business owners immensely. I would also like to mention that this changing environment underlines the importance of the Small Business Administration (SBA) and the many important programs it oversees that also serve this function. I was glad to learn that hearings on how the SBA can further aid the capital acquisition process are planned for the near future.

Madame Chairman, thank you again for providing this forum to learn more about these issues. I look forward to subsequent hearings that will delve into the specifics of particular private capital opportunities for small business. I appreciate our distinguished panel for being here today. Your expertise and time are essential to this process, and I look forward to your testimony.

Testimony of
William J. Dennis, Jr.
National Federation of Independent Business

Madame Chairman, thank you for this opportunity to present evidence on small business credit conditions. My name is Denny Dennis. I am a Senior Research Fellow with the NFIB Education Foundation here in Washington. My remarks are presented on behalf of the National Federation of Independent Business, an organization with whom I have been associated in one position or another for almost 20 years.

Small Business Capital Sources

An individual's personal wealth is the single most important source of finance used to form to a new business. Business profit (earnings) is the single most important source of finance for reinvestment in the firm. These twin facts imply that small business owners and potential owners must be able to save and retain capital which, in turn, implies that tax and regulatory policy have a major direct influence on the number and growth of American small businesses. While I understand that the focus of this hearing is not tax nor regulatory policy, a thorough airing of small business finance issues must at some point recognize the influences of each. The capacity to tap debt or equity capital has no meaning without the ability to generate and save enough wealth to enter a business or to expand it.

While personal resources retain paramount importance in financing small businesses, other sources are significant as well. Table 1 presents the percentage of small businesses that obtained credit lines, loans and leases from selected suppliers in 1993. The most important of these is the commercial banking system. Finance companies, family and individuals, and leasing companies are the next most important sources. Trade credit (60.8%), business (27.6%), personal credit cards (39.2%), and loans from the owners (16.7%), not presented on Table 1, are the nontraditional sources of credit most commonly employed.

TABLE 1
PERCENTAGE OF BUSINESS THAT OBTAIN CREDIT LINES, LOANS, AND LEASES BY SELECTED SUPPLIER - 1993

Supplier	Percent
Any	55.5
Commercial Bank	37.0
Savings Institution	3.9
Thrift	2.3
Finance Company	11.8
Leasing Company	7.5
Other Nondepository Fin. Inst.	1.2
Family and Individuals	8.0
Other Businesses	6.2
Government	0.5
Unknown	1.4

Source: 1993 National Survey of Small Business Finances, *Federal Reserve Bulletin*, July, 1995 Supply and Demand for Small Business Finance

Most small business owners can get most of the capital they need most of the time. *Small Business Problems and Priorities*, an NFIB survey report last conducted in late 1991, found that small business owners ranked "Obtaining Long-Term (5 yrs or more) Business Loans" their 46th most serious problem (out of 75), "Obtaining Short-Term (less than 12 months or revolving) Business Loans" their 53rd most serious problem, and "Obtaining Investor (Equity) Financing" their 69th most serious problem. Those figures tell only part of the story, however. A small, but important segment rated finance problems as very serious for their business. Thirteen (13), 11 and 7 percent respectively attached the "critical" assessment. *Small Business Economic Trends*, a monthly publication based on NFIB survey data, reported in January, 1996, that four percent considered "Finance/Interest Rates" as their single most important problem. That figure is a two to three percentage points below the figures typically recorded in '94 and '95, but equal to or above those found in '92 and '93. NFIB's *Credit, Banks, and Small Business* series (latest in 1995) provides respondents nine common complaints, e.g., unexpected changes in credit terms, about banks and asks which one represents their most serious concern. Twelve (12) percent cited "availability of credit." "Interest rates charged," "none; no serious concerns," and "collateral requirements" were named more frequently and "fees and service charges" was named with the same regularity.

Small Business Economic Trends also shows that throughout 1995 approximately five small business owners were able to obtain all the debt capital they needed within the prior three months for every one who could not. That ratio is subject to change due to business cycles among other things. In early 1993, when many were still feeling the effects of the '90-'91 recession, the ratio was 3-1. Extending the period from three months to three years, i.e., were respondents able to borrow all the money they wanted over the last three years ('92-'94), the ratio fell to 2¾-1. A small, but additional number -- perhaps one borrower in 10 -- were able to get credit, though not all they want.

Financing is a smaller problem for starts than is popularly recognized. I have seen data which will not be released for at least a year suggesting that a relatively small portion of those who start a business consider financing their single most difficult start-up problem. (The Entrepreneurial Research Consortium of which the NFIB Education Foundation, SBA, and several universities are members will likely also address the issue soon.) The reason appears to be that a large number of starts are in the services which usually require relatively more human than physical capital. For example, about one in four of the *INC*. 500 begin with less than $5,000 in physical capital. In addition, second mortgages and personal loans are easier to obtain than in the past. These resources can be used to finance a start when somewhat larger sums are required. Further, the increase in the number of dual income families provides a base standard-of-living meaning that the amount to be held in reserve for living expenses during the initial months of the venture is reduced.

The Problem: Finance Gaps

The finance problem for small business is a series of gaps in the credit and equity markets. Some are more serious than others. Some appear more subject to remedy than others. But gaps are problems. They also explain why the overwhelming share of the small business owner population will tell you, when asked directly, that finance is not a serious business problem, while at the same time you will hear vociferous complaints that small business finance is almost impossible to obtain.

Let me isolate six gaps and address each:

1. Starts -- For reasons already noted, financing starts is less difficult today than it was in the past and than it is in popular perception. However, problems remain. For the most part these are equity rather than debt problems. It is not clear that banks should be lending money to start-up ventures beyond amounts financed by second mortgages or personal loans.

The start finance gap does not appear to be serious among the smallest firms, although there are individual cases where that is not true. Americans finance millions of starts every year. Larger starts, which are less frequent, are another issue. About one in 10 full-time business starts currently have equity investors (not friends or family). These investors are known as "angels." Often other business owners (presumably sophisticated investors) provide sums as small as $5,000 to well into the hundreds of thousands. A typical investment is on the smaller side, perhaps $25,000.

Bill Wetzel, the country's leading authority on angel financing, estimates that angels currently provide between $10 and $20 billion involving 30,000 to 40,000 deals. He believes there is demand to double that amount of investment. The problem is the match-making process. Potential angels are not eager to broadcast that they want to invest and entrepreneurs are not eager to reveal what they believe to be their market edge. Then, there are market imperfections such as regional imbalances. They are exacerbated by impediments such as state securities barriers. Thus, "angels" represent an important resource with potential for expansion.

What about institutional venture capital? It rarely funds starts and it usually prefers deals involving more than one million dollars.

2. Rapidly Growing Businesses -- Rapidly growing firms are usually voracious consumers of capital. They not only require enough cash to support normal operations, e.g., inventories, payroll, but enough to finance expansion, e.g., new facilities, at the same time. These businesses have a second characteristic, important for present purposes. They don't grow steadily. More often they grow in the pattern of a sine curve, i.e., a snake.

Lending to these firms is very difficult. They need money seemingly all the time, but the lender can never be quite sure if a downturn is the prelude to another upturn or the precursor of disaster. There is a huge up-side to lending to these firms. If successful, the business will eventually stabilize and the bank will certainly enjoy the inside track for a profitable relationship. But banking is not a high risk-high reward business.

Equity capital again appears to hold greatest potential. But as with starts, matching angels and entrepreneurs is not always easy. Institutional venture capital funds some of these opportunities. However, the number is limited for a variety of reasons. For example, a potential recipient may reside in an area void of venture capital firms. Or, the owner may skip an offer because he has to surrender too much control, and control is a primary reason many enter in the first place.

3. Business Cycles -- Business cycles continue to have an important disruptive effect on small business capital demands. Covering the last 22 years, data from *Small Business Economic Trends* exhibit an inverse relationship between business cycles and changes in small business credit conditions. As business activity slows, more owners report increased difficulty meeting their credit needs, and vice-versa. Though the NFIB series on credit satisfaction is too recent to include the last recession, the ratio of borrowers with satisfied credit needs regularly increased throughout latter 1993, '94 and '95.

Though the condition of each firm differs, the primary reason for the credit/cycle relationship is that balance sheets deteriorate as the cycle heads down. A deteriorating balance sheet makes some borrowers ineligible for a loan when they might well obtain a loan under ordinary conditions. Those who do receive credit may obtain less than desired or may be subjected to conditions not normally present.

The size of this gap is difficult to measure since demand for credit also declines during cycles. One characteristic of the last recession -- other than New England's special situation -- was the unusually large decline in demand for debt capital. Part of the solution may lie in greater variability in lender rates as will be discussed subsequently.

4. Transitions -- During the late 1980s and early 1990s, the banking system in the New England area was undergoing a major transition. Real estate problems and a recession among other factors caused several banks to founder. The industry restructured. But it caused severe disruption for many small business owners. As one wag observed, 'it's pretty tough to borrow when the bank's doors are locked.'

A second example occurs on a more localized level. Bank take-overs and mergers can cause problems. About one in four small business owners reported that between '92 and '94 their principal bank had undergone some change in ownership structure. Less than half felt no effect from the change. A healthy majority reported problems, though it wasn't clear these were tied to credit availability issues. Monday's *USA Today* reported a study from the New York Fed that mergers resulted in a larger share of small business loans to assets. I have not yet seen the study.

5. Marginal -- A fine line may separate a marginal acceptance from a marginal rejection. While that line must always exist, the goal is to secularly shift that line toward the accept side. I later offer some thoughts about how that can be done.

6. Troubled Businesses -- There are some businesses for which neither further debt nor further equity capital are appropriate.

<u>Concluding Observations</u>

Economic theory argues that we adjust price for risk. As the father of a teenage son who just earned his driver's license, I can personally assure you that some businesses follow theory. But bank lenders do not. Rather than adjust price for risk, they adjust risk for price. Banks charge small business owners between one and three points over prime, or its fixed rate equivalent. If a potential borrower does not have a risk that fits the price interval, the loan is rejected. But what makes 1-3 sacred?

The base issue for small business is availability, not price. Price becomes an issue only after availability is assured. Thus, greater variability of interest rates seems like a wise market response to small business credit needs. It helps banks by allowing them to profit from a greater number of borrowers; it helps marginal borrowers and those caught in cycles obtain credit when they might not otherwise; and, it may even help the gilt-edged borrower by making prices more responsive to their minimal risk.

I am not arguing for higher rates. I am arguing for great availability. If that requires higher rates for riskier borrowers, so be it. Remember, it will still be cheaper than credit cards, the current high cost alternative.

Second, let me defer to Professor Wetzel regarding the steps that need to be taken to increase equity capital, particularly from "angels." I can only regurgitate what he argues, and not nearly as articulately.

Third, I remain curious as to the reason(s) why small business asset-backed securities have not become a reality. They appeared to hold potential when the Banking Committee explored them a few years ago. I received calls from two or three organizations around the country which seemed poised to proceed. Yet, nothing seems to have developed. What's the problem?

Finally, if we can temporarily overlook the savings and loan fiasco, deregulation of the nation's lending institutions has brought increased competition to small business. While the commercial banking system still holds the lion's share of small business's financial business, small business owners see a variety of institutions within and without the industry increasingly competing for their patronage. Nineteen ninety-five data indicate that 38 percent of polled owners believed there was more competition for their firm's business among financial institutions than three years prior. Only 20 percent reported increased competition in 1980. Of course, not all competition involves financing. But, financing is one important implied ingredient. It is important that vigorous competition be encouraged.

There is one serious cautionary note on which I conclude: the artificial inflation of the housing market in the 1970s and 1980s provided enormous equity against which home-owners could borrow to form or expand a business. In my judgment, this huge source of equity contributed in no small measure to a surge in business formation over the last quarter century. But housing markets have changed enormously over the last five years or so. Equity is no longer building, at least not in the proportions it once did. That means younger business owners and potential owners no longer can draw on that net worth to secure their borrowing.

NAM National Association of Manufacturers

MANUFACTURING MAKES AMERICA STRONG

SMALL BUSINESS ACCESS TO CAPITAL

TESTIMONY OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
BY MURRAY A. GERBER
PRESIDENT AND OWNER
PROTOTYPE & PLASTIC MOLD COMPANY

BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 28, 1996

1331 Pennsylvania Avenue, NW, Suite 1500 - North Tower, Washington, DC 20004-1790
(202) 637-3000 • Fax (202) 637-3182

Manufacturing:

The Key to Economic Growth

- The United States was rated number one in overall global competitiveness by the World Economic Forum in 1994, and again in 1995.
- U.S. manufacturing productivity growth averaged more than 3 percent over the last decade, compared with less than 1 percent growth in the rest of the U.S. economy.
- U.S. manufacturing's direct share of the Gross Domestic Product (GDP) has remained remarkably stable at 20 percent to 23 percent since World War II. Manufacturing's share of total economic production (GDP plus intermediate activity) is nearly one third.
- A change in manufacturing output of $1 results in a total increase of output throughout the economy of $2.30.
- The U.S. share of world exports in manufactured goods is now 12.9 percent, up from 11.6 percent 10 years ago.
- Manufacturing provides the bulk of technological advances and innovation for the economy.

SMALL BUSINESS ACCESS TO CAPITAL

TESTIMONY OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
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FEBRUARY 28, 1996

Good morning. My name is Murray Gerber. I'm President and Owner of Prototype & Plastic Mold Company in Middletown, Connecticut, a 27-year-old family-owned plastics manufacturing firm with 80 employees. I have twice been named state Small Businessman of the Year, am a three-time delegate to the White House Conference on Small Business, a member of the NAM Board of Directors and former chairman of the Connecticut Business and Industry Association, Inc.

The National Association of Manufacturers (NAM) is the nation's oldest and largest broad-based industrial trade association. Its nearly 14,000 member companies and subsidiaries, including approximately 10,000 small manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. Through its member companies and affiliated associations, the NAM represents every industrial sector and more than 18 million employees.

We appreciate this opportunity to testify regarding the problem of small business' access to capital and to discuss not only personal experiences but our suggestions for improving the access of smaller, capital-intensive manufacturers. The National Association of Manufacturers has made economic growth the keystone of our agenda for the '90s. Growth will only come with the active participation of small manufacturers which, in turn, requires a strong and open access to capital.

As I indicated, I have served in several capacities as a representative of small businesses, so while I speak to you of my personal experiences I am a spokesman and advocate for many small businesses.

For the most part, my knowledge is Connecticut-based, which I suspect is an extreme case because of the long recession, changes in the banking environment and many bank failures and mergers. But I think the Connecticut experience is helpful in understanding the situation. What happened to Connecticut small businesses can happen anywhere.

CONNECTICUT CREDIT CRUNCH HISTORY

First, let me offer a little history:

The events that have caused the Connecticut credit crunch began with a decline in the real estate values that collateralize most of our notes, was pushed by the presence of

energetic federal regulators fresh from their "success" in Texas, was compounded by difficulties in several basic industries such as the military and insurance, and by the general slowing of the economy as the nation slid into recession in 1991.

These conditions led to thousands of companies having their notes "classified" or considered risky -- usually due to the decline in real estate values -- and many called in. Solid companies with notes current or with hundred-year histories of survival experienced problems with their bankers, most with land and real estate assets that were temporarily depressed. Alternate financing was not available, so many companies failed. So, too, did the banks.

This was followed by the "Merger and Acquisition" period. The number of banks went down dramatically, with a tremendous concentration of assets in a small number of banks and ownership of the major banks moving outside of Connecticut. New banks were unable to start up in such a milieu, thousands of bank employees lost their jobs and staffs were reduced in the face of falling business and the absence of new loan-making. After a few years of cleaning out and selling off the classified loans, even the work-out staffs were laid off.

It was during this time that I tried to refinance my own company, which is structured as an S Corporation. While my company's loans were not called, because we had put the company on a debt reduction program, we did experience a classified loan problem. New,

additional capital was not available. The only sources of credit were programs from the State of Connecticut: programs to prevent companies from leaving the state (which we were considering) and a program to assist manufacturers. These worked for me at the time, but they were and remain thoroughly inadequate to the task of providing financing for all the small manufacturers that needed help.

THE SITUATION TODAY

Banking in Connecticut today is dominated by a small number of large banks all headquartered outside the state. The enclosed article from *The Connecticut Economy* provides significant details about the situation, but my own conversations with small businesses throughout the state lead me to several conclusions --

- Bank staffs no longer have the ability or the need to make smart "business" lending decisions. Due to lay-offs, inadequate staffs simply no longer have the ability to service these loans.

- Despite the fact that banks widely advertise that they have money to lend to small businesses, the standards are so strict and the amounts so low that even those who qualify cannot borrow as much as they want or need. Banks now require collateral twice the size of the loan, or demand three sources of cash to pay off the loan.

- Small businesses have learned to "do without" or find capital outside the banking system. We are now in a transition period in which "non-bank banks" are attempting to fill the void left by commercial banks, but there is not yet sufficient capacity in those institutions to satisfy demand.

- "Start-ups" have virtually nowhere in the banking system to go.

- Most small businesses have less borrowed capital than they want or need to maximize sales, thereby inhibiting investment, growth and expansion.

- The amount banks have loaned to small businesses is disproportionately small compared to the small business share of the GDP, or the importance of small business to our economy. And the small business share of those loans is going down!

SOME SUGGESTED SOLUTIONS

I fear that the businesses that do not start today, or that start and can only grow through savings are not going to be adding jobs in five years when they traditionally reach their rapid growth period.

For example, in 1981, my small company was one of the first in the nation to acquire

a $500,000 state of the art CAD/CAM system. To accomplish this, I needed to take advantage of an Investment Tax Credit, Safe Harbors lease which lowered the interest by 5 percent and accelerated depreciation. In those days, there were Industrial Revenue Bonds to reduce interest rates too, all of which were aids to acquire capital and stimulate investment.

These tools to stimulate capital investment are now gone. Today we have higher tax rates on S Corporations, which affects more than a third of all small manufacturers; the Alternative Minimum Tax which punishes small businesses that acquire a lot of depreciable property and few credits and depreciation schedules which aid the cash flow of small businesses.

Proposals like the expensing provision which have been discussed in this committee are helpful to non-capital intensive companies, but a manufacturing firm -- however small -- has capital requirements far exceeding the expensing provision limitations.

Herewith, then, a few suggestions --

- Improve the cash flow of growth-oriented S Corporations by passing H.R. 2911, sponsored by Rep. Phil Crane, which would eliminate the over-taxation of retained earnings by S Corporations. Currently, the shareholders of S Corporations are taxed at a rate of up to 41 percent. Rep. Crane's legislation

would cap that tax on funds used to pay taxes or reinvested in a company at 34 percent.

- Repeal the punitive Alternative Minimum Tax. This is not a "big business" tax. This is a tax that is destroying the ability of even small companies to invest, grow and create new, good-paying jobs.

- Encourage non-bank banks, making certain sources of capital are available to them. To turbo charge the economy, small business lending must be encouraged.

- Pass legislation recommended by the 1995 White House Conference on Small Business regarding access to public finance markets, including:

  - Improving the ability of public and small and large private company pensions, profit sharing, 401(k) plans, individual IRAs, Keogh and SEP plans to invest in small business ,

  - Facilitate the ability of an individual to invest up to half of his or her own retirement funds in a specific small business of his or her own choice,

- Relax collateral and income-to-debt ratio requirements to allow banks to make smaller loans based on character, personal background and credit worthiness,

- Reduce the number of federal agencies regulating banking and require bank regulatory agencies to reduce paperwork commensurate with loan size, and

- Establish a tax-free rollover provision for the gains on sale of assets or ownership interests in a small business that are reinvested or rolled over into another small business within one year.

Madame Chair, I appreciate and commend this Committee and its members for their awareness and interest in what is a very serious impediment to small business growth, and ultimately to the growth of the American economy.

This concludes my prepared testimony. I appreciate this invitation and opportunity to express my views, and would be pleased at this time to address any questions you or other members of the Committee might have.

The Small Business Credit Crunch

By Edwin L. Caldwell

As noted in the October 1995 issue of *The Connecticut Economy*, since 1993 commercial banks have been required to segregate in their call reports for the second quarter of each year the number and amount of their small business loans in three size categories: less than $100,000, less than $250,000, and less than $1,000,000. These are considered small business loans on the assumption that the great majority of loans this small are made to small businesses. These data are now available for three years, the second quarters of 1993, 1994, and 1995. Formulated by the Federal Reserve Bank of Boston, the data allow some judgment about the validity of the almost universal complaint of small businesspeople, that the commercial banks are falling short of meeting their credit needs.

Magnitude of Business Lending

To paraphrase the late Senator Everett Dirksen's famous remark about the federal budget, a few million here and a few million there and pretty soon you're talking about real money. It is clear from the numbers in Table 1 that we're talking about some real money here. The numbers in parentheses in the small business rows designate the percentages small business loans are of total business loans. These percentages fell between 1993 and 1995 in every state except Rhode Island, where they held steady. And the absolute amounts of small business loans fell between 1994 and 1995 in each state except Massachusetts and New Hampshire.

Table 1: Business Lending in $millions by New England Commercial Banks

	1993-II	1994-II	1995-II
Connecticut	8703	8029	10,653
Sm. Bus.	(36) 3143	(36) 2865	(23) 2481
Lg. Bus.	5560	5164	8172
Massachusetts	27,691	30,045	32,535
Sm. Bus.	(19) 5287	(18) 5392	(17) 5467
Lg. Bus.	22,404	24,653	27,068
Rhode Island	4660	4625	4570
Sm. Bus.	(22) 1031	(22) 1034	(22) 1015
Lg. Bus.	3629	3591	3555
Vermont	1837	1832	1820
Sm. Bus.	(73) 1338	(69) 1261	(69) 1250
Lg. Bus.	499	571	570
New Hampshire	1390	1293	1454
Sm. Bus.	(70) 969	(70) 900	(67) 981
Lg. Bus.	421	393	473
Maine	2613	2717	2712
Sm. Bus.	(60) 1561	(59) 1601	(57) 1583
Lg. Bus.	1052	1116	1174
New England	46,894	48,541	53,744
Sm. Bus.	(28) 13,329	(27) 13,053	(24) 12,732
Lg. Bus.	33,565	35,488	41,012

Numbers in ( ) represent percentages Small Business loans are of total loans

Source: Developed by *The Connecticut Economy* based on data from the Federal Reserve Bank of Boston.

C&I Loans vs. CRE Loans

Business loans are divided into two categories for reporting purposes, commercial and industrial (C&I) and commercial real estate (CRE). Figure 1 shows recent developments in these categories for large business loans and Figure 2 for small business loans. Figure 1 establishes that there were substantial increases in the amount of large C&I loans in most of the New England states between 1993 and 1995. The increase in Connecticut in 1995 was especially large. By contrast, there were marked decreases in the amount of large CRE loans in most states in both 1994 and 1995. This no doubt reflects the fact that the region has not fully absorbed the surplus commercial building that took place in the eighties. Figure 2 presents a rather clear picture of what Connecticut small businesspeople are complaining about with respect to C&I loans. These loans underwent substantial decreases in amount from 1993 to 1995 while the large C&I loans were experiencing a major increase. The size of the decreases in small CRE loans probably reflects the sizable vacancy rates that exist around the state.

Sizes of Small Business Loans in Connecticut

Tables 2 and 3 should be read together. From Table 2 you see that 12,500 out of a total of 15,900, or 79%, of small C&I loans in Connecticut in the second quarter of 1995 were for amounts less than $100,000. From Table 3 you read that these loans amounted to only $289 million out of total small business loans of $945 million, or 31%. By contrast, small C&I loans of $250,000 to $1 million numbered only 1,400 out of the total of 15,900, or 9%, but came to $451 million, or 48% of the total. With respect to small CRE loans, the numbers of the three categories are similar, but the dominance of the $250,000 to $1 million group in dollar volume is even greater than with the C&I loans — 71%.

Table 2: CT Small Business Loans by Size Numbers of Loans (thousands)

	1994-II	1995-II	% Chg.
Commercial & Industrial	16.4	15.9	-3.0%
Up to $100,000	12.4	12.5	0.8%
$100,000 to $250,000	2.3	2.0	-13.0%
$250,000 to $1 Million	1.7	1.4	-17.6%
Commercial Real Estate	9.5	7.9	-16.8%
Up to $100,000	3.2	2.2	-31.3%
$100,000 to $250,000	3.1	2.8	-9.7%
$250,000 to $1 Million	3.2	2.9	-9.4%

Source: Developed by *The Connecticut Economy* based on data from the Federal Reserve Bank of Boston.

Table 3: CT Small Business Loans by Size ($millions)

	1994-II	1995-II	% Chg.
Commercial & Industrial	1074	945	12.0%
Up to $100,000	270	289	7.0%
$100,000 to $250,000	253	205	-19.0%
$250,000 to $1 Million	551	451	-18.1%
Commercial Real Estate	1791	1536	-14.2%
Up to $100,000	162	95	-41.4%
$100,000 to $250,000	412	353	-14.3%
$250,000 to $1 Million	1217	1088	-10.6%

Source: Developed by *The Connecticut Economy* based on data from the Federal Reserve Bank of Boston.

Who Makes the Small Business Loans

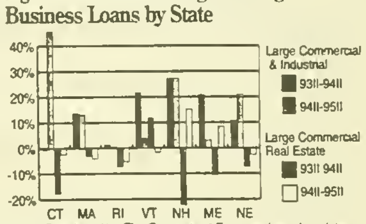
A recent study by the Federal Reserve Bank of Boston shows the distribution of the dollar volume of small business loans held in 1994 by New England commercial banks of several asset sizes. Banks with assets less than $100 million held 8% of the total; $100 million to $300 million, 20%; $300 million to $1 billion, 20%; $1 billion to $5 billion, 20%; and over $5 billion, 32%. Thus the big banks are the major players in small business lending at present.

But the Federal Reserve notes that the recent trend has been for the smaller banks to expand their small business loans the most aggressively, while the big banks have been contracting this activity. Since the big banks account for about one-third of total small business lending in New England, as noted above, they are probably the source of the pinch small businesspeople complain about.

But there is the possibility of change in the wind. Perhaps small business lending will become more attractive for the big banks. The argument runs like this. Small business loans are potentially very profitable for any size bank because they usually carry a higher rate of interest than big loans. But this advantage can be offset by higher costs of administration per dollar lent. It doesn't take much less administrative effort, and hence cost, to make a $1 million loan than a $50 million loan. And it takes a lot more effort to administer fifty $1 million loans through to their termination than to do the same for a $50 million loan.

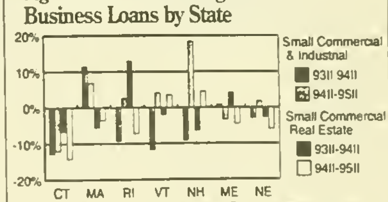
Thus if the big banks could get a better handle on administrative costs, they might become more enthusiastic about small business loans. There is some hope that this might occur as the result of the present downsizing and merger activities. But it is too early to tell.

Figure 1: Percent Change in Large Business Loans by State



Source: Developed by *The Connecticut Economy* based on data from the Federal Reserve Bank of Boston.

Figure 2: Percent Change in Small Business Loans by State



Source: Developed by *The Connecticut Economy* based on data from the Federal Reserve Bank of Boston.

BIOGRAPHICAL NOTES - MURRAY A. GERBER

* **GRADUATE** M.I.T., Mechanical Engineering, 1956
* **GRADUATE** University of New Haven, MBA, 1979
* **FOUNDER** and **PRESIDENT** of Prototype & Plastic Mold Co., Inc. a 27-year-old company specializing in limited-life injection molds and short-run injection molding of plastic parts
* **Vice Chairman - MEMBER**, Executive Committee & Chairman of Advancement & Development Committee University of New Haven
* **MEMBER**, Connecticut Small Business Advisory Council
* **DIRECTOR**, Middlesex County Chamber of Commerce - Chairman - Manufacturers Council
* **CHAIRMAN** Health Affairs Council CBIA
* **MEMBER** DEC District Export Council
* **CHAIRMAN**, Connecticut Business & industry Assn. (CBIA) 1989
* **CHAIRMAN**, Connecticut Public Expenditure Council (CPEC) 1987-1990
* **CHAIRMAN**, Meriden-Middlesex Private Industry Council 1986-1989
* **MEMBER** Connecticut Blue Ribbon Commission on Health & Office of Health Care Advisory Board
* **EX-DIRECTOR**, Connecticut Chapter, Smaller Business Association of New England (SBANE)
* **Ex-Member**, Middlesex Community College Foundation
* **EX-DIRECTOR**, Connecticut Tooling & Machining Association (CTMA)
* **EX-MEMBER**, Board of Directors Value Care Inc.
* **EX-MEMBER**, National Political Action Committee, National Tooling and Machining Association
* **CHAIRMAN**, Connecticut Business & Industry Association Ad Hoc Committee on Estate Tax Reform, 1983
* **VICE CHAIRMAN**, Ct. Delegation to White House Conference on Small Business, 1980; Co-Chairman of Delegation at 2nd meeting 1985; Member of Delegation White House Conference III, 1995
* **CHAIRMAN**, 1982 Connecticut Conference on Small Business
* Connecticut Small Business Advocate of Year 1983, also 1990 (Award from SBA)
* Connecticut Small Business Person of the year 1987 Award from State of Ct. Dept. of Economic Development
* Small Business Person of the Year 1991 Award from SBA
* Jr. Achievement of South-East Connecticut's Free Enterprise Hall of Fame - 1990
* **GUEST LECTURER:** NYU Graduate School of Management
  Soc. of Plastics Engineers: Ct., MA & NY City
  Tooling & Machining Assoc: Ct. Chapter
  Society of Manufacturing Engineers
  Waterbury State Technical College
* Amateur oenologist
* Avid but incompetent: Golfer, Bridge Player, Photographer

C. Virginia Kirkpatrick, President of CVK Personnel Management & Training Specialists, St. Louis, MO Director on the Financial Services Council of NAWBO

Testifying on Behalf of the **National Association of Women Business Owners, Washington, DC**

TESTIMONY FOR THE COMMITTEE ON SMALL BUSINESS ACCESS TO CAPITAL HEARINGS - February 28, 1996, 10:00 A.M.

SOURCES OF CAPITAL FOR SMALL BUSINESS:

Small business start-ups most often go to friends and family for loans to start their business after they have committed all of their own available savings, and perhaps the equity in their home. They also use credit cards and put earnings back into the business to finance the growth for the first one or two years.

SBA loans - 504 for building and/or real estate acquisitions, 7A programs for funding to finance the operations of the company; and also the Low Doc and Prequalified Loan Programs, are most commonly used by small businesses. In my experience SBA guaranteed loans are the largest source of funding for small business.

Women business owners who more often start service companies use their credit cards extensively and may also use the equity in their home and/or loans from friends and relatives

to start and grow their business. Women owned businesses are undercapitalized a majority of the time and growth is definitely hampered because of the lack of funds.

The small business with two-three years of successful operation can usually obtain bank loans to cover operating expenses and expansion of their business. Start-ups are still generally unable to obtain bank loans.

There have been some changes in the trends, but the changes are a matter of degree, not significant change.

I work with small businesses as a consultant, serve on the board of a small steel manufacturing company and on the board of a community bank, as well as serve on the loan committee of a that community bank in St. Louis. My personal observation is that the availability of capital to small businesses from bank loans fluctuates somewhat with the competition for loans in the community, and the regulatory environment. . . i.e. How much the bank's loan portfolio is criticized by the bank examiners. Following the failure of the Savings & Loans, the regulatory environment was extremely tight and critical of loans made on any other basis than sufficient collateral to ensure the loan.

Currently, the banking environment in the Midwest is very competitive. And, the customer does benefit from the competition for deposits and loans.

Securities offerings require considerable cash, no matter how simple, and most small businesses need cash. I am one of the original shareholders and on the Executive Committee of the Board of a Missouri based bank holding company with 2 banking locations in northern Missouri and 5 banking locations in the St. Louis Metropolitan Area. We registered our stock this year and are now listed in the NASDAQ Over the Counter market because the legal fees were in the $80,000 range compared to an Initial Public Offering (IPO) cost of about $1 million. We will probably need to raise additional capital in the future and will consider an IPO. Lots of small businesses I know would be happy to have the $80,000 it cost to register stock.

Venture Capital seems to be available to certain small businesses as seed capital for start-up and/or growth in relatively large amounts of several million. (Most venture capital funds have a minimum amount in the millions - not in the thousands). Companies with break-through technology or high-potential products, and in some instances companies with "niche" markets, seem to have enough potential to attract Venture Capital dollars. It is my observation that Venture Capital is not available to the mass of small businesses.

To my knowledge institutional investors, insurance companies, pension funds and mutual funds, do not provide capital for small businesses to any significant extent. These groups are more interested in making a few, large long term loans to finance large projects, buildings, etc.

Some recommendations to replace government involvement in the role of making capital available to small businesses.

HR 2806 was introduced in the House on December 18, 1995. This bill would amend the SBIC Act and create the Venture Capital Marketing Association. This mechanism would make it possible for small business loans to be securitized after the FNMA model in residential housing. We know how to do it, the laws need to change to make it possible.

Regulations need to continually be reviewed to allow banks to make loans based on a high probability of repayment because of the character of the business owner. Collateral should not be seen as the principal source of repayment. More competition among banks, not less, is beneficial to the customer. Obviously banks cannot make loans that have a low probability of repayment; however, if banks can sell insurance, mutual funds, etc., they can serve customers better and have more fee income to offset lower interest rates on loans. Again, the consumer benefits!

Private sources <u>will</u> fund small business when the incentive and the mechanisms are in place. Trying to force private sources such as banks, venture capital funds, institutions, etc. to make loans to small business is not the answer. Providing the incentive in a win-win environment for <u>both</u> the small business and the private funder <u>is</u> <u>one</u> of the answers.

SMALL BUSINESS
LEGISLATIVE
COUNCIL

TESTIMONY OF
THE SMALL BUSINESS LEGISLATIVE COUNCIL
BEFORE THE
HOUSE COMMITTEE ON SMALL BUSINESS
ON THE SUBJECT OF
ACCESS TO CAPITAL

FEBRUARY 28, 1996

1156 15th Street, N.W. - Suite 510 Washington, DC 20005 (202) 639-8500 / FAX (202) 296-5333

Access to capital. I feel this is a subject that could be best covered by Thomas Pynchon — stream of conscious; no beginning; no middle and especially no end.

As you know, the Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. For your information, a list of our members is attached.

The more I labor in the field of small business, the more I realize that the capital problems and solutions of a small business are unique to each individual small business but common to all. Start-up or growth, lifestyle or high tech research, there are countless variables to alter the equation. A dozen years ago, I would have spoken confidently of trends. Now, I am not as confident, but as reluctant as I am to generalize, it is a reluctance I conquered many years ago, so let's plunge ahead.

There is no question the overwhelming number of entrepreneurs begin with no previous financial experience or access to formal capital.

A frightening number of them start off with their own informal capital, rely on savings, credit cards, and other financial sleight of hands, to finance their fledgling businesses on a strictly "cash flow minus" basis. I use the term, cash flow minus basis, because these companies, whether or not ultimately successful, become very adept quickly at juggling accounts payable. One might say they are running one step behind at all times, but they survive.

I have not seen any figures with which I am comfortable, that quantify the growth of this phenomena. But I do believe this source of capital has grown significantly. I do know that consumer debt has grown significantly and also that it is much easier to secure individual credit in the first place and to obtain bigger credit lines. Our guess is that a bigger chunk of this so-called consumer debt is really business debt than it was a decade ago.

This informal micro-loan market is critical to the current start-up environment. On one hand we could say, "that is what it is all about, welcome to the world of risk taking." On the other hand, it probably makes the case for a greater emphasis on a more efficient, formal micro-loan program delivery system.

Your letter of invitation asked us to testify with "an emphasis on how the private sector, rather than the government, can meet the capital needs of small business as we reduce the burdensome role that government has historically played in the lives of small business men and women in this country."

When you strip away the veneer, private sector investment motivation comes down to three things: "It's a relative," "I'm going to make a killing on this sure thing," or "My accountant tells me I can get one heckuva tax break."

We cannot do much about acts of marriage or bloodlines, and I know there are no sure things except death and taxes, so that leads me to the third option — private sector investment and the tax code.

Throughout our history (SBLC will be celebrating its twentieth anniversary in 1997), one of our guiding principles has been that the tax code should be used to direct economic activity to encourage the growth of small businesses. This principle has led us to participate, over the years, in debates ranging from restoration of a capital gains rate differential to the establishment of a direct expensing provision.

Capital gains is very much a small business issue. Throughout the life-cycle of a small firm, capital gains plays a vital role. It contributes to business continuity and the preservation of the family-owned enterprise. While there will always be debate over whom are the beneficiaries of a long-term capital gains exclusion, it is important not to lose sight of the valuable contribution a capital gains rate differential has made to the vitality of the small business economy and job creation.

The role of capital gains is most obvious at the birth of a small business. In particular, it serves as a catalyst to investment by both the informal and formal venture capital communities. It is the organized venture capital market that seeks out and encourages the innovative high-growth firms that are the creators of jobs in our economy. Studies over the years have demonstrated a strong correlation.

Venture capital investment is not without significant risk, however, nor is the return on the investment immediate. The capital gains differential enhanced the venture capitalist's ability to take the risks that have paid dividends in the form of jobs to the economy.

Capital gains has its populist side as well. The government's 1987 *State of Small Business Report* noted that informal investors — friends, relatives, and business associates — are the second most commonly used source of equity capital financing after internal financing. The report stated, "preliminary estimates indicate that total informal equity capital investment in small businesses amounted to approximately $300 billion in 1983." Altruism aside, the informal network does expect a return on its investment, and capital gains has been a part of that equation.

The tax treatment of capital assets also has an impact on the corporate cost of capital. In a world where our trading partners and competitors enjoy a much lower cost of capital, a corporate capital gains adjustment can help make us more competitive in the world market place.

The SBLC has historically supported the concept of allowing small business owners and investors to defer or roll over their gains if they hold their investment in a small business for a longer period of time, and/or reinvest the proceeds in small business. Such a proposal has been prominent in all three White House Conferences on Small Business.

Second, depending on the assets involved and the tax status of the business, expansion of the direct expensing provision of the tax code, Section 179, will provide more opportunities for small business to invest in capital purchases. Currently, Section 179 allows small businesses to write off the first $17,500 of such purchases in the first year. SBLC was among the most prominent private sector advocates of Section 179 when it was considered and enacted by Congress in 1981. Small business "finances" many of its capital asset investments from retained earnings. Waiting five or seven years to recover that investment is a significant deterrent to further growth and expansion. Again, this proposal was prominent in all three White House Conferences.

Retained earnings are absolutely critical to small business. In the 1970s when changes were made to the corporate rate structure, the impact on small business was addressed by creating a graduated corporate rate structure. At the time, Congress acknowledged the importance of allowing small businesses the opportunity to accumulate those earnings.

There remain hard feelings about the 1993 Omnibus Budget Reconciliation Act among those successful small businesses that do business as S Corporations. They felt the sting of the increase in the top individual rates. The short term obvious salve is to reduce those rates, but I believe the long term access to capital issue suggests that we need to rethink how we tax small business income. Every time we get into a "class warfare" debate and whether to increase taxes for the wealthy, small businesses are pulled in through their S Corporation status. We need to find a way to make a distinction between personal wealth and business income.

One might say, "Well why don't these small businesses simply become C Corporations." The answer is there are other distinct advantages to the tax treatment of S Corporations depending on their point in the life cycle of the business. We need to find a way to retain those advantages without penalizing them as innocent bystanders in the "class warfare" debates.

Moving from the impact of tax policy on access to capital, I would like to focus on federal programs that increase private sector investment by leveraging limited government resources.

We have always been strong supporters of the equity investment programs of the Small Business Administration (SBA).

We accept the thesis that job creation and innovation are the basis for taxpayer risk taking through these programs. We are satisfied that the successes have offset the losses over the years. Equity in the $250,000 to $3 million range is the life blood of new business and is hard to come by. The broader venture capital community appears to have moved beyond the traditional small business investment. It appears to us the venture capital community is "doing" bigger deals (e.g., $10 million), more conservative investments, and more foreign investments. The Small Business Investment Companies

(SBICs) stand out, more than ever, as the source of capital to the entrepreneurial base of this country.

We believe we have entered an exciting new era for the SBIC program with the changes made by Congress in 1992. In terms of capital formation, more private capital ($475 million) has been invested in SBICs in the last two years than in the last decade. We understand, for example, that the New Hampshire Employee Retirement Fund is an investor in an SBIC. As I will note below, we are convince that public and private pension funds are an untapped source of capital for small businesses.

As has been widely reported already, the participating securities SBIC program has already produced a profit dividend for the government, and more are on the way.

At this point, our assessment is that the taxpayer's investment in the SBIC is a good one, and the best thing we can do is ensure reasonable growth and stability for the program. In this budget era, that is no small feat, but we do believe it is worthwhile to aspire to those twin goals. It is a public-private partnership that is working.

I wish I could be as sanguine about the loan programs of the SBA, essentially the guaranteed loan program. I know you have often heard me tell that story about SBLC and the telephone book. We often get calls meant for SBA because we are one of the few private sector groups listed in the business section that begins with the words "small business."

I can tell you from those telephone calls, notwithstanding government downsizing, there are a lot of would-be entrepreneurs and small business owners who believe the government should be a lender of first resort rather than a lender of last resort.

I do believe the government can perform a role, but only as a lender of last resort. The marvelous thing about an SBA loan is its term. Yes, it is not cheap money, but for a business living from hand to mouth, SBA loans do not make the crushing dent in cash flow that other debt might produce. On balance, I believe it is a very useful program but I emphasize again that the government should be the lender only of last resort, and that the program should not function as a convenient profit center for some lenders. I

know you have been working hard to make adjustments to the program, and I hope are succeessful in putting the intent of the program back in perspective.

For businesses "up and running," working capital for inventory and payroll is the principal concern of the day. Cash flow is king. I cannot tell you how many conversations I have had with small business owners over the last months who describe a changing sales pattern. We seem to be moving to an economy of "fits and starts." The sales chart is one with higher spikes and deeper valleys. At the end of the year, the proverbial bottom line may be a profitable one, but the journey there is marked by more intensive activity and deeper lulls than ever before. And this is true regardless of sector.

For awhile, it appeared the lending community was putting the squeeze on lines of credit and other such working capital financing. Four years ago, this was a major concern for us and we were convinced this was due either to the reality of, or perceived concern regarding, excessively stringent bank regulation. I do not get that same sense of urgency now. Most of the changes that have been made to ease up on bank regulation seem to have bore fruit, at least with respect to this specific type of capital. Trade credit is also an important element of such capital. At the present time, our impression is this credit is also loosening somewhat (whether by choice or reality is another matter).

We have long been supporters of the community bank. I do not care what anybody else says, I do not believe we will ever see the day someone produces the perfect software to evaluate a small business loan. There are a lot of small business ventures out there that you have to feel, taste, and kick. Instincts still are an important part of the equation.

Community banks are locally owned and operated. They have local boards of directors that have the interests of the local economy at heart. Their officers, who are typically long-time residents of their areas know the individuals and their families. They are willing to make loans based on the character of the applicant, and not just the numbers. This counts for a lot when a young person, woman, business, or minority

owner — who may not have extensive business experience or credit history — comes in for a loan.

The statistics bear out this community bank role. *Bank Call Report* data shows that banks with less than $100 million in assets make up 10 percent of banking deposits, but those same banks make 28.2 percent of the loans under $100,000. Financial institutions with assets of less than $300 million lend the majority of dollars in amounts of less than $250,000 (45.6 percent), and the loans that small businesses rely upon.

One of the top priorities of small businesses over the past 15 years has been to have a creditor that knows the business person and his or her business. Community bankers meet this priority by being an integral presence in the community — one well acquainted with the businesses in the community and their owners. Local bankers have an incentive to consider the interests of the towns and cities where they live and where their banks do business. Community banks also have the power to respond to the needs of the small business by being flexible and adaptable to their needs — because they are not constrained by policies set by managers in offices hundreds of miles away.

Our sense is that modest "growth and expansion" debt financing is more readily available today. There are a variety of state and local vehicles for securing this financing and generally there is more substantial collateral available. I am not prepared to say the supply of this capital is adequate, but compared to other capital needs this type of help appears to be more abundant.

We are certain we can do more to encourage the investment of pension funds into small businesses. Without jeopardizing the integrity and soundness of hard-earned retirement funds, perhaps we should examine the standards we apply in such situations. If I am not mistaken, some creative thinking could be applied to how much and what type of non-qualifying assets pension managers are allowed to invent, to expand access to this capital.

I hope this gives you some sense of what the current capital situation looks like to us and what we can do to facilitate access to capital through the private sector.

Thank you.

SMALL BUSINESS LEGISLATIVE COUNCIL

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance for Affordable Health Care
Alliance for American Innovation
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Equine Practitioners
American Association of Nurserymen
American Bus Association
American Consulting Engineers Council
American Council of Independent Laboratories
American Gear Manufacturers Association
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Interior Designers
American Society of Travel Agents, Inc.
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehouse Association
AMT-The Association for Manufacturing Technology
Architectural Precast Association
sociated Builders & Contractors
..sociated Equipment Distributors
Associated Landscape Contractors of America
Association of Small Business Development Centers
Automotive Service Association
Automotive Recyclers Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Council of Growing Companies
Direct Selling Association
Electronics Representatives Association
Florists' Transworld Delivery Association
Health Industry Representatives Association
Helicopter Association International
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Communications Industries Association
International Formalwear Association
International Television Association
Machinery Dealers National Association
Mail Advertising Service Association
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Mechanical Contractors Association of America, Inc.
National Association for the Self-Employed
National Association of Catalog Showroom Merchandisers
National Association of Home Builders
National Association of Investment Companies
National Association of Plumbing-Heating-Cooling Contractors
National Association of Private Enterprise
National Association of Realtors
National Association of Retail Druggists
National Association of RV Parks and Campgrounds
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Chimney Sweep Guild
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Food Brokers Association
National Independent Flag Dealers Association
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Ornamental & Miscellaneous Metals Association
National Paperbox Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Wood Flooring Association
NATSO, Inc.
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Power Transmission Representatives Association
Printing Industries of America, Inc.
Professional Lawn Care Association of America
Promotional Products Association International
The Retailer's Bakery Association
Small Business Council of America, Inc.
Small Business Exporters Association
SMC Business Councils
Society of American Florists
Turfgrass Producers International

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NATIONAL SMALL BUSINESS UNITED

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Statement of

Robert Smith
Spero-Smith Investment Advisors, Inc.
Cleveland, Ohio

Regarding
Small Business Credit and Capital Issues

Before the
House Small Business Committee

February 28, 1996

Madame Chairman and Members of the Committee:

Good morning. My name is Bob Smith, and I am a partner in Spero-Smith Investment Advisers, Inc. Cleveland, Ohio. I am Chairman of the Credit & Capital Formation Committee within National Small Business United, and I also serve on the board of The Council of Smaller Enterprises of the Greater Cleveland Growth Association, which is the largest local small business organization in the nation and a member of National Small Business United. I very much appreciate the opportunity to testify today on the vital issue of access to capital for the nation's smaller businesses. As a small business owner, and a financial adviser to small businesses, I can tell you that the importance of small business capital formation and financing cannot be overstated. But since it is routinely ignored, we are especially grateful that this hearing is occurring today.

We sincerely commend you and the other members of the Committee in placing a high priority on this extremely important area of policy. It may seem redundant to say it because it is now generally well-understood, but let me reiterate it once more: Continued economic growth, especially that which will create job growth, will be dependent on a strong and vital small business sector. Without small business leading the way, economic growth will stall, ensuring economic dysfunction for an extended period.

In the long-run, small business must be able to obtain affordable long-term capital for renewal of physical assets, training of the workforce, conversion of technologies into useful, competitive products, and for research and development of new technologies. Since World War II there has been a chronic shortage of affordable long term capital for small and medium-sized companies in the United States. This shortage has improved after having been especially acute in the late 1980s and early 1990s. At that time, various regulatory and economic forces caused the U.S. financial institutions to become even more risk-averse than they would be normally. So, while the credit and capital formation situation is certainly better for small business now than it has been, it could certainly stand improvement, preferably *before* the next "credit crunch".

I. General Comments on Small Business Financing

The nation's community of small businesses, now numbering almost 20 million, is unique in the world, in its size, its makeup, and its vitality (with respect to business formations and failures, the risks taken, and the productivity and innovation exhibited year after year). Indeed, even if the industrialized world forms the triad of multi-trillion dollar economic blocs that some economists and futurists predict, the U.S. will have one "ace" that neither Europe nor Japan have: a dynamic and diverse small business community that is the "engine" of job growth. But we must have national policies which encourage

(or at least do not discourage) small business growth if that advantage is to last over time. Ensuring adequate access to credit and capital is one of the most critical needs small business will have in that respect.

However, the very size and diversity of the small business community challenges public policymakers when they seek to address one or another facet of small businesses' needs. This is especially true in finance, as the types, amounts, frequency and even the form of financial requirements vary widely within the sector. Of the country's 20 million small firms:

- More than 15 million are unincorporated companies, such as sole proprietorships and independent contractors that have no additional employees; and
- About 5 million have at least one additional full-time employee and range up to 500 employees.

The first group has a high birth/death rate, usually has initial financing from owner/proprietor capital and derives operating capital from ongoing profit/cash flow, supplemented by micro-loans, either from local banks or, more recently, individual credit cards. The second group contains within it companies with a broad variety of business plans, cultures and owner aspirations regarding expected financial payback.

Some small businesses "lifestyle" companies in which the owners derive financial payback on a year-to-year basis from the cash flows generated by the firms. Usually these are relatively closely-held companies and rely on bank financing to supplement the company profits. Generally there is little interest in utilizing equity as a fund-raising device (except as security for loans); even if there were interest by the owners, there would be little interest by outside investors, except as an acquisition. Most of these firms are kept within a family or are sold to another entity (or the employees) when the owners want to cash out.

Another group of small businesses are, to one degree or another, growth companies where the owners intend to realize their financial payback via the increased valuation of the company stock. Owner liquidity is derived either from public offerings or sale of the business; less frequently, dividends provide added ongoing shareholder return. These firms can be of interest to outside investors, public or private. Public investors derive payback via increased share values and dividends. Private investors expect their paybacks via increased share valuation and, in some cases, payouts to preferred stockholders. The investors' desired liquidity is derived from various "exit" schemes, including public offerings, sale of the company and ESOPs, among others.

It is important to review these small business characteristics because the types of financing mechanisms available to small enterprises vary with their operating goals, characteristics and owner aspirations.

II. Survey Results

According to a survey of the small business community sponsored by NSBU and the Arthur Andersen Enterprise Group conducted during the spring of 1995 (1996 results will be released in June), nearly one third of small businesses used no outside financing in the previous year. Of those that did use outside funds, bank loans were by far the most popular means. Thirty-six percent of businesses with fewer than 20 employees had commercial bank loans, but 68 percent of those with 20-99 employees had commercial bank loans, and 70 percent of those with 100-500 employees had commercial bank loans. But the smallest businesses used other sources of credit not used by the larger businesses. For those with fewer than 20 employees, 17 percent had personal loans, and 27 percent used credit cards as a form of financing.

In addition to a far greater utilization of commercial loans, the larger companies, not surprisingly, were far more likely to utilize the issuance of stock, selling of accounts receivable, or leasing to satisfy their capital needs. Moreover, these larger (though small)

companies were half as likely as their smallest counterparts to have used no financing in the previous year (15 percent to 30 percent, respectively). We have attached a full copy of the Financing section of these survey results in the attached appendix.

These results show the diversity of small businesses. Small businesses cut across the full range of business types. For this reason, Madame Chairman, financing of small businesses must be looked upon as multi-faceted, not as a monolithic problem to be solved with a single panacea or "silver bullet." If we are to take steps to improve the ability of small businesses to have affordable access to credit and capital, it needs to be through a series of small progressive steps. No single approach can possibly satisfy the full range of small business needs.

III. Small Businesses and Banks

Banks are unquestionably the single most important financing source for small businesses. But during the last 20 years, the relationship of small businesses and bankers has undergone substantial change, and this change has been both good and bad. On the hand, there are now many more potential avenues for small businesses to obtain financing than there were in the past. However, the relationship that many small business owners had with their banks has badly deteriorated or disappeared.

Over the last few years, there has been an enormous concentration of investment capital into the hands of institutional investors. This concentration is happening at the same time that the banking industry is consolidating. In 1980, there were 12,600 U.S. banks. By 1990, there were only 9,600 banks. This trend toward consolidation continues unabated.

Some of this consolidation has been driven by government regulations. Given the numerous regulations burdening banks, there are certain economies of scale that are created. Whatever the reasons, small businesses are now more likely to be faced with an institutional mentality that makes “objective” decisions about loans based upon a set formula. Given the diverse nature of the smallest businesses, such a system obviously puts them at a disadvantage. This disadvantage will continue to be compounded in the future as small businesses seek ways to lure the enormous capital pools of institutional investors. These investors are most likely to invest in a secondary market that securitizes small business loans or investments. The criteria demanded for these investments is likely to be even greater than at present for loans. So, for growth-oriented firms that are beyond the start-up phase, the credit and capital future is not so glum. However, for the typical member of the small business community, fighting to survive, more access to capital is needed.

While we are often skeptical of more government programs to solve small business problems, we have also been encouraged by the (growing) success of the SBA 7(a) loan program. As that program has been increasingly privatized over the last few years, its success in meeting small business loan demand has been marked. Certainly the guaranteed loan program helped to mitigate the recent credit crunch, and has been a crucial link in the improving credit environment for small businesses today. Chairman Meyers, you have played a crucial role in designing the program as it works today, and we are very grateful that you have kept the needs of small businesses foremost in your mind. This 7(a) program is one that works.

IV. Potential Solutions

Perhaps the single most important action that could be taken to encourage investment in small businesses is the enactment of capital gains incentives that reward long-term investment. NSBU certainly supports the broad-based capital gains tax relief that is currently on the table, but we would rather see an approach that lowers rates as the holding period increases. This approach would greatly encourage long-term investment and encourage investment in small businesses. Investors in small businesses cannot expect quick returns or regular dividends. Instead, such investments are rewarded by

long-term capital gains at the point of sale. Lowering taxes on the those long-term gains encourages investment in small businesses.

Such tax reform could also encourage additional venture capital backing of small business. But there is also another important avenue for small businesses to attract equity investment: The Small Business Investment Company (SBIC) program. We at NSBU think it is finally time to begin considering a privatization of the SBIC program, in order to improve small business access to this excellent source of capital. We think there is reason to believe that increased privatization of the program will open up additional capital sources for new markets. We congratulate Congressman Torkildsen on his new bill to accomplish these goals, and we hope that we can work with him to continue to develop these ideas.

I believe the other two areas where we still need significant improvement for small businesses involve: 1) increased bank lending and 2) new avenues for institutional investments.

Increased bank lending will be difficult to achieve, and I am not sure that any changes in federal regulation or policy are the most important components of increased bank lending.

Instead, it is probably time to challenge, or at least examine, big banks' new promises to increase lending to small businesses.

We currently have on the books a law that requires banks to report on their small business lending activities, and the SBA Office of Advocacy has done a fine job of compiling and publishing those results. It is probably time for organizations like NSBU--or even better, local organizations such as COSE--to take a serious look at those statistics and compare them to the promises now being made by big banks. A good analysis which is widely distributed could keep small business lending on the front burner for many big banks. We must also ensure that this reporting requirement is not repealed. We want to thank you, especially Mrs. Meyers, for your efforts last year to keep this reporting requirement in place. It is crucial information.

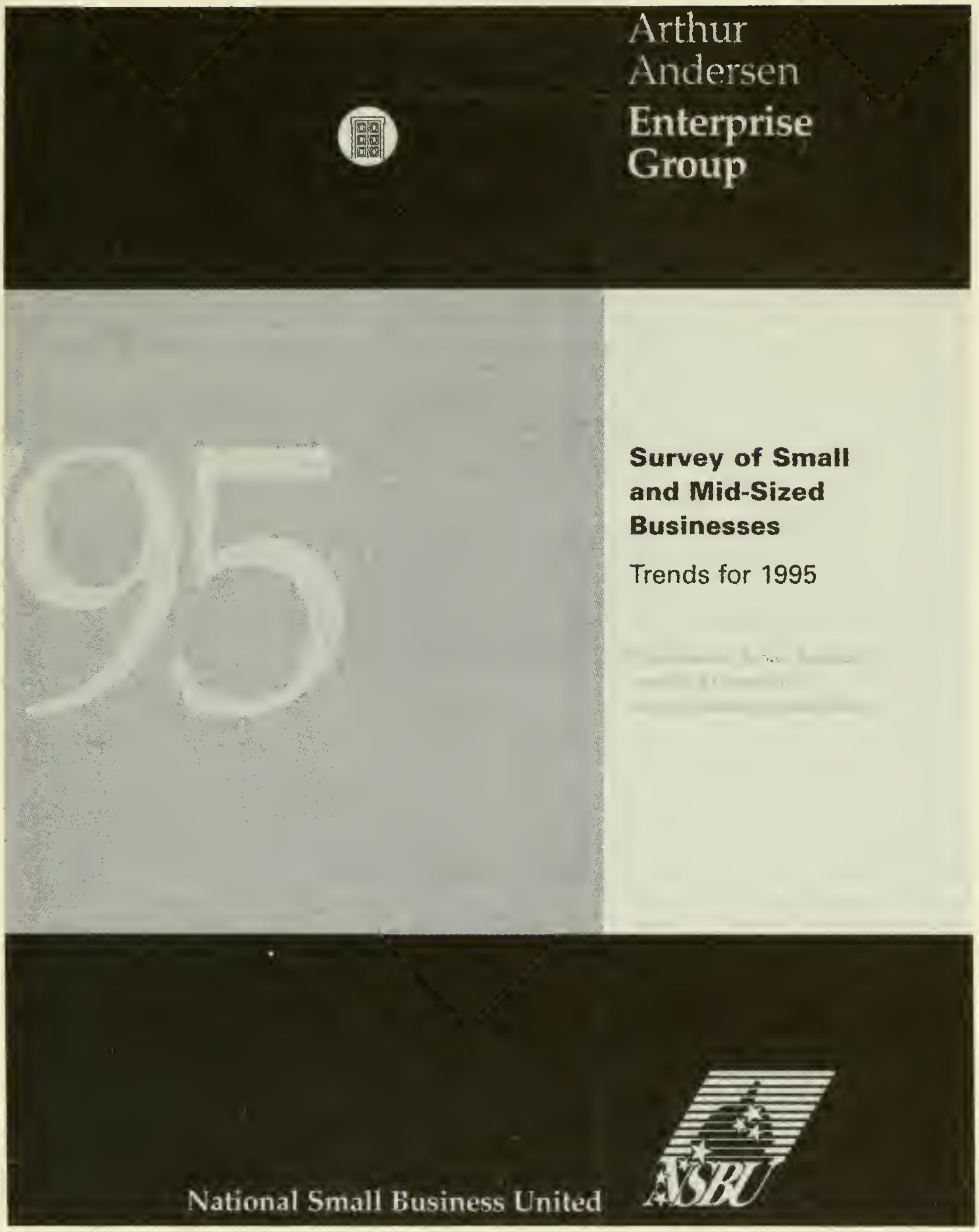
One major source of small business capital lies largely untapped: institutional investment. Mostly made up of pension fund investments, these funds are invested almost everywhere but in small businesses. The major reason for this lapse is that these investments do not have marketability or liquidity. The most promising way to attract institutional investment into small business appears to be to create a securitization device which can pre-package small business loans and sell them into secondary markets.

Direct investment of funds into individual small businesses is probably unrealistic, as far as we can tell.

Legislation which passed in the last Congress attempted to reduce the regulatory impediments which stand in the way of increased securitization of small business loans. Despite this legislation, we have seen little evidence that private securitization efforts have taken hold. It is probably time to examine this issue more closely in order to determine what else could be done to facilitate those efforts.

V. Conclusion

In this statement we have only lightly touched upon some of the complex issues that arise in the small business credit and capital arena. We hope you will be able to explore many of these issues in more depth in your upcoming series of hearings. Please remember that the small business community is a very diverse sector, with many different needs. We must have a financing system which provides many different avenues for different sorts of businesses to finance new ventures. We hope to continue to work with you on these issues and to provide whatever input you might find valuable. Thank you.



Arthur Andersen
Enterprise Group

Survey of Small and Mid-Sized Businesses

Trends for 1995

95

National Small Business United

NSBU

Foreword

We are pleased to provide you with the findings of our fourth annual Survey of Small and Mid-Sized Businesses. We hope you will agree, this survey is one of the most comprehensive of its type, and it yields information that simply is not available elsewhere.

The survey is part of our ongoing effort at Arthur Andersen's Enterprise Group and National Small Business United to understand and represent the concerns of the nation's economic engine.

The scope of this market is vast, and it represents an incredibly diverse group of businesses. For this reason, you will find many of the findings reported in this booklet broken down by company size, age, region, industry and rate of growth. It is our intent to provide an insightful look into this market.

The findings of this survey are presented to the media and key policy-makers in the administration and Congress. They also are distributed to small and mid-sized businesses across the nation including: NSBU member businesses, Arthur Andersen Enterprise Group clients, survey participants and others.

As the history of this survey builds, we will continue to identify and follow trends in the small and mid-sized business community. By continuing to share knowledge we hope to build a common understanding that will guide federal policy-making and private-sector initiatives to support our nation's economic growth.

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Contents

Executive Summary

Their economic outlook is positive. Their expectations for growth are the highest in four years. Their access to capital has improved. And, their challenges to growth and survival have abated, somewhat.

Is this a year of roses for the owners and executives of small and mid-sized businesses?

The economic data on the first few pages of this booklet offer a mostly affirmative response. However, amidst an improving economic landscape, there are several significant challenges. Not surprisingly, small and mid-sized businesses have taken several steps to keep their economic prospects strong.

The Labor Challenge
Labor issues dominated the list of growing challenges this year. Specifically, labor costs, lack of qualified workers and the cost of training workers are being cited as significant challenges by a growing number of businesses. And, fast-growing companies are finding it particularly difficult to find qualified employees. Findings include:

- Twenty-five percent cite "lack of qualified workers" among their most significant challenges, up from 20 percent in 1994 and 13 percent in 1993.
- Labor costs rank as the second most significant challenge for small and mid-sized business owners.

The Cash Flow Problem
This year, approximately three-quarters of small and mid-sized businesses were able to obtain adequate financing. Yet, a hidden challenge may lie just around the corner. Despite optimistic forecasts, many growing companies run into financial trouble. Why? Management often underestimates the financing required to support the company's growth.

Witness this year's survey findings. They reveal that companies with adequate financing perform much better than do their inadequately-financed counterparts. Yet, inadequately-financed companies are predicting about the same levels of growth for the coming year. Findings include:

- Last year, revenues grew an average of 4.8 percent at adequately-financed small and mid-sized businesses, but only 1.4 percent at companies that say they are inadequately financed.
- Inadequately-financed companies project the same level of sales growth next year as the adequately-financed companies, 6.3 percent.

The Cost of Health Care
The health care crisis is not as top of mind as it was a year ago. Twenty-four percent of small and mid-sized business owners, down from 42 percent in 1994, list health care insurance benefits among their most significant challenges to growth and survival. A slowdown in the rate of premium increases may offer some explanation. The average increase in premiums was 9 percent in 1995, substantially less than the 14 percent reported in 1994, 22 percent in 1993 and 21 percent in 1992. However, insurance-related costs continue to outpace inflation and are one of the main contributors to labor costs. And labor costs are one of small and mid-sized businesses greatest challenges.

International Expansion
More than ever, small and mid-sized businesses are going global. Twenty-six percent now export their goods, a significant increase from 20 percent in 1994 and 16 percent in 1993. Importing activity is also on the rise. The companies most likely to export are also growing the most rapidly - reporting nearly twice the increase in sales, profits and hiring as small and mid-sized businesses on average.

Technology Implementation
Fast-growing companies are really taking advantage of new technologies. Nearly six in 10 of those companies that grew their workforce by 10 percent or more also upgraded their computer systems. And, small and mid-sized businesses overall are plugging in, with 80 percent using computers, 30 percent planning major upgrades next year, 22 percent using on-line services and 13 percent regularly accessing the Internet.

Small Business and the Economy

America's economic engine.

For years, small and mid-sized businesses have been identified as the engine of our economy – an essential ingredient for a strong and vibrant future. As our economy changes, small business continues to grow and change too. Today, approximately 20 million businesses in the United States are identified as "small businesses," companies that employ fewer than 500 people.

It is clear that the future health of the U.S. economy depends on small business since they:

- Employ almost 60 percent of American workers.
- Provide two-thirds of initial jobs and most of the initial on-the-job training in basic skills.
- Contributed to an economic recovery by creating the nation's net new jobs for the period 1987 to 1993.
- Account for 52 percent of all sales in the United States.
- Provides half of private sector product.
- Increased in number by 49 percent since 1982 in the United States.

Although small and mid-sized businesses are an important generator of the U.S. economic activity, they still face many burdens that limit their potential. During the 3rd White House Conference on Small Business, June 11 – 15, 1995, thousands of small business owners serving as delegates made their concerns known to the Clinton Administration and Congress. Through their recommendations on issues ranging from capital formation to regulation and paperwork, WHCSB delegates hope to open doors of opportunity and growth for the small business community.

With all the contributions small and mid-sized businesses have made to the economy, there's little to doubt that they are indeed America's economic engine.

Sources

The State of Small Business, SBA, Washington: 1994.

National Small Business United, Washington: 1993.

Who's Creating Jobs?, Cognetics, Inc. 1994 Edition.

Methodology and Demographics

Arthur Andersen's Enterprise Group and National Small Business United contracted with L.C. Williams & Associates, Inc of Chicago, to conduct a nationwide research study of small and mid-sized businesses.

A survey was mailed to 8,550 small and mid-sized business owners across the United States. To learn more about the different segments within this population we employed a stratified random sample in which an equal number of surveys went to businesses with 1-19, 20-99 and 100-499 employees. Within each group, businesses were selected randomly.

A total of 919 completed surveys were returned to L.C. Williams & Associates in May 1995.

Percentages reported in the survey have been computed from a "valid case base" which excludes minimal levels of non-response on an item-by-item basis. The 1994 and 1993 surveys employed the same methodology - 1992 percentages that appear in this year's study were recomputed to exclude non-response.

To ensure that the survey results represented a proper distribution by company size for the small and mid-sized business market, the results were weighted by the most current U.S. Bureau of the Census business establishment data. The charts throughout this report are based on these weighted percentages.

The following demographic information is based on the weighted sample of businesses that responded to the survey. For reference purposes, the percentage of actual respondents (unweighted) is also included.

Number of personnel currently employed by business

	Weighted	Unweighted
0 - 19	87%	32%
20 - 99	10%	38%
100 – 499	2%	26%
500+	1%	4%

Number of years in business

	Weighted	Unweighted
0 – 3	5%	2%
4 – 10	24%	15%
11 – 15	19%	14%
16+	52%	70%
Average	**14 years**	**15 years**

Revenues for most recent fiscal year

	Weighted	Unweighted
Less than $100,000	13%	4%
$100,000 to $499,999	31%	10%
$500,000 to $999,999	15%	8%
$1,000,000 to $4,999,999	28%	28%
$1,000,000 to $149,999,999	12%	49%
$150,000,000 or over	1%	1%

Location of business

	Weighted	Unweighted
Northeast	18%	19%
North Central	25%	33%
South	20%	24%
West	37%	24%

Gender

	Weighted	Unweighted
Men	83%	91%
Women	17%	9%

Highest education

	Weighted	Unweighted
Post-Graduate Degree	24%	26%
University Degree	39%	48%
Technical Diploma	9%	6%
High School Diploma	26%	18%
Other	2%	2%

For more information or additional copies of this report, contact Laurence Hayward of Arthur Andersen at 312 507 1295 or Linda Gimbel of NSBU at 202 293 8830.

Economic Outlook/ Performance

Economic Outlook Improves

Percentage of respondents who expect an increase in revenues, profits, employees and employee compensation

More small and mid-sized businesses expect an increase in revenues, profits, employees and employee compensation this year than last. In fact, there has been a consistent upward trend in these forecasts over the last four years.

Expected Level of Growth

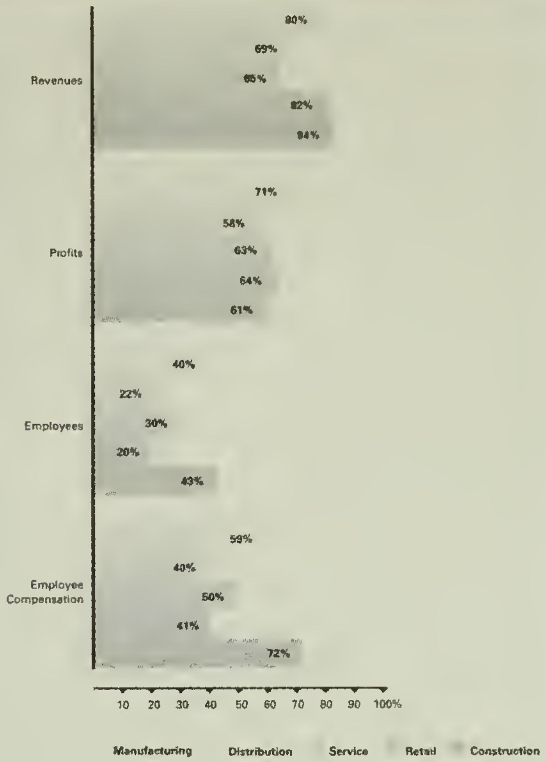
Expected percentage change in revenues, profits, employees and employee compensation in 1993, 1994 and 1995

With respect to the amount of growth, on average, small and mid-sized businesses forecast a 6.4% increase in revenues, 4.8% increase in profits, 1.8% increase in employees and a 2.6% increase in employee compensation over the next 12 months. The level of growth expected in each of these areas is higher than in previous years.

Expected Growth by Industry

Percentage of respondents who expect an increase in revenues, profits, employees and employee compensation

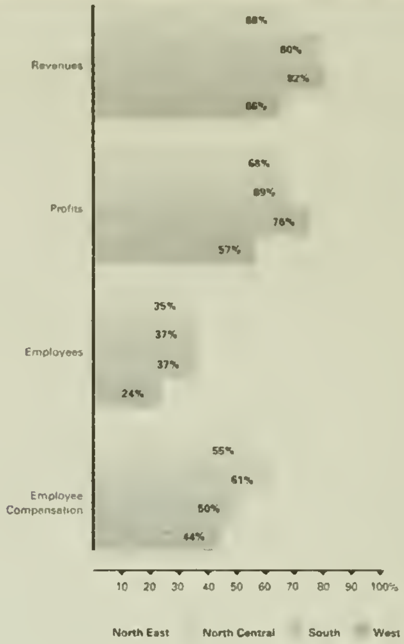
Companies in the manufacturing, retail and construction industries are more likely to expect revenue growth. Further, manufacturing and construction companies stand out as those that expect to expand their workforce and increase compensation.



Expected Growth by Region

Percentage of respondents who expect an increase in revenues, profits, employees and employee compensation

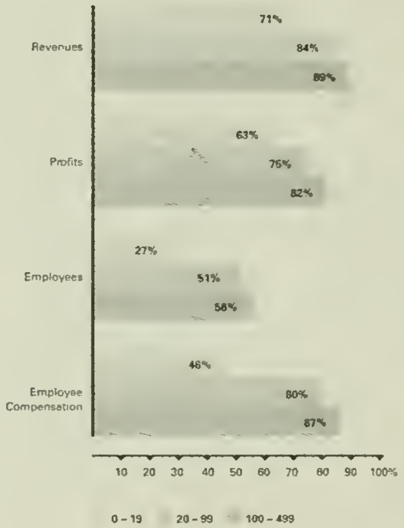
Small and mid sized companies in the North Central and Southern regions of the U.S. are generally more optimistic than companies in the North East and West.



Expected Growth by Size

Percentage of respondents who expect an increase in revenues, profits, employees and employee compensation

Generally speaking, a greater percentage of the larger companies (as defined by number of employees) expect increases in revenues, profits, employees and employee compensation over the next 12 months than do their smaller counterparts.



Economic Performance - Level of Growth Past 12 months

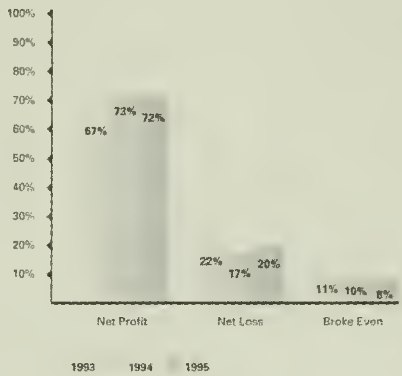
Percentage of respondents who expect an increase in revenues, profits, employees and employee compensation

While small and mid-sized businesses showed improvement in all four performance indicators over the last two years, most notable are the significant increases in the employ ment and employee compensation.

Economic Performance - Net Profits

Percentage of respondents who reported a net profit in their last fiscal year

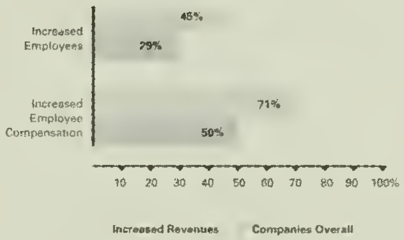
The percentage of small and mid-sized businesses earning a net profit has remained relatively stable over the past three years, hovering around 70%.



Does Revenue Growth Translate to Employment Growth?

Percentage of respondents who recorded increased employment in the last twelve months

Small and mid-sized companies that increased revenues within the last 12 months were also significantly more likely to increase their workforce and increase employee compensation.



Who's Hiring? Who's Not?

Percentage increase in workforce

The average increase in employment and employee compensation was highest among those companies that have invested in R&D, increased revenues, were in business four to 10 years and had between 100-499 employees.

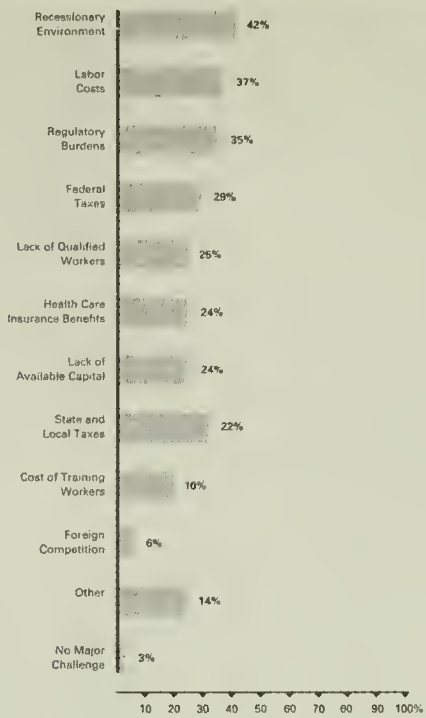
It was lowest for companies that recorded a decrease in revenues, do not use computers and are in the retail and distribution industries.

Those companies that posted a revenue loss experienced, on average, a 2.3% decrease in their workforce

Challenges to Growth and Survival

Percentage of respondents naming the following as one of the three most significant challenges to the growth and survival of their business

This year's top challenges include a recessionary environment, labor costs and regulatory burdens.

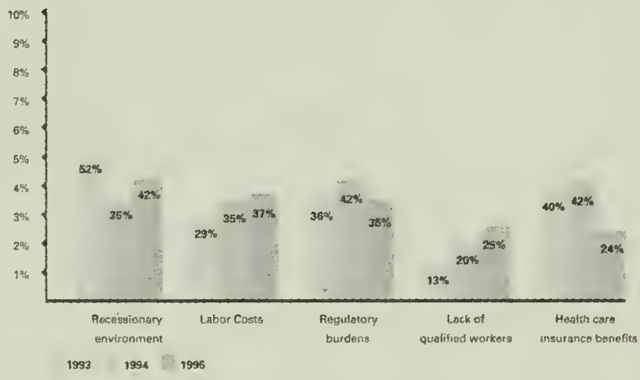


What's Different This Year

Percentage of respondents naming the following as one of the three most significant challenges to the growth and survival of their business

Labor-related issues such as labor costs, lack of qualified workers and the cost of training workers have received more mentions each year by small and mid-sized businesses - listing them among their most significant challenges.

Meanwhile regulatory burdens, federal taxes, health care insurance benefits, lack of available capital and state and local taxes received significantly fewer mentions this year than in previous years.



Top Challenges by Region

Percentage of respondents naming the following as one of the three most significant challenges to the growth and survival of their business

Small and mid-sized businesses in the North East and West were significantly more likely to cite a recessionary environment and government regulations as their top challenges.

Companies in the North Central and Southern regions of the U.S. were significantly more likely to view labor costs and lack of qualified workers as their top challenges. Not incidentally, companies in these regions also were most likely to have expanded their workforce in the last 12 months.

Business Operations/ Technology

Organizational Change

Percentage of respondents indicating they made the following changes in their business over the last 12 months

The most common organizational changes made by small and mid-sized businesses this year included upgrading computer systems, developing new products and services, and improving productivity.

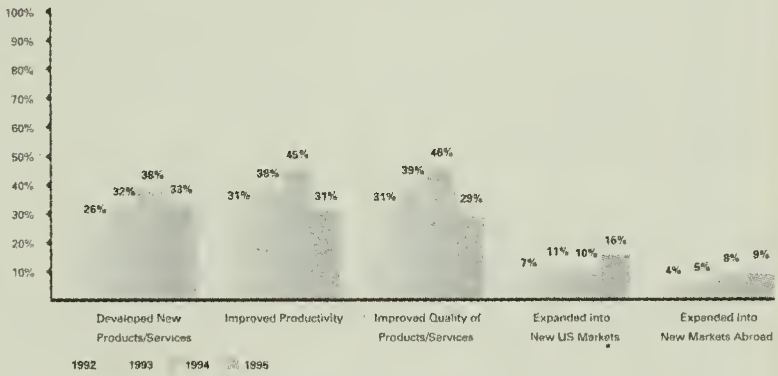
However, one in four made no substantial changes to their business within the last 12 months.

How this Year is Different

Percentage of respondents indicating they made the following changes in their business over the last 12 months

Fewer companies developed new products/services, improved productivity and improved quality this year than last. However, these changes had steadily increased in each of the previous three years.

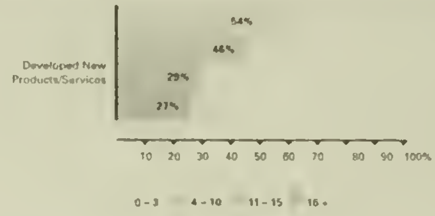
More companies expanded into new U.S. markets and expanded into new markets abroad in the last 12 months than had in previous years.



Age and Creativity

Percentage of respondents indicating they made the following changes in their business over the last 12 months

The younger the company the more likely it was to have developed a new product or service within the last 12 months.



Business Changes by Size

Percentage of respondents indicating they made the following changes in their business over the last 12 months

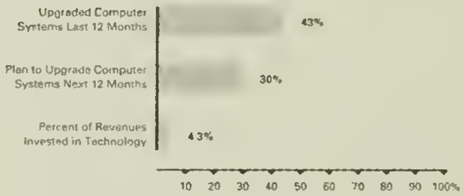
Generally speaking, the larger businesses in the survey were significantly more likely to have made substantial changes in their business in the last 12 months than the smaller ones.

	0 – 19	70 – 99	100 – 499
Upgraded computer systems	40%	60%	60%
Developed new products/services	31%	44%	54%
Improved productivity	26%	54%	70%
Improved quality of products/services	26%	46%	51%
Increased investment in business	19%	50%	54%
Expanded into new U.S. markets	13%	22%	29%
Expanded into new markets abroad	7%	12%	20%
Instituted Total Quality Management	7%	14%	19%
Opened new stores or branches	4%	8%	17%
Other	5%	4%	6%
No substantial changes	30%	8%	3%

Technology Investments

Percentage of respondents indicating the following

Forty-three percent of small and mid-sized business upgraded their computer systems within the last 12 months and nearly one-third expect to next year. On average, small and mid-sized businesses plan to invest 4.3% of their revenues in systems technology for the coming year.

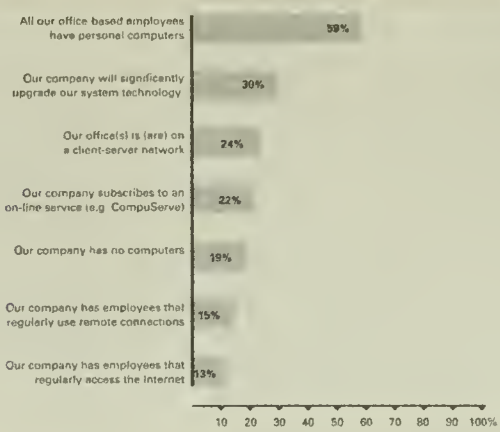


Use of Technology

Percentage of respondents indicating the following applies to them

Fifty-nine percent of small and mid-sized businesses stated that all of their office-based employees have personal computers. Thirty percent plan system upgrades. Nearly one in four are on client-server networks and subscribe to on-line services. Fifteen percent use remote connec-tions and 13% regu-larly access the Internet.

Approximately one in five small and mid-sized businesses have no computers at all.



Characteristics of Computer Users

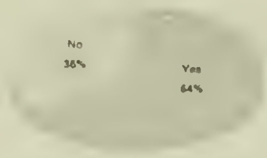
The following table compares small and mid-sized businesses on several attributes with regards to whether the company uses computers or does not

Have Computers	Attribute	Do Not Have Computers
More employees (average size of 28 employees)	Size	Fewer employees (average size of 5 employees)
Average 13 years in operation	Age	Average 15 years in operation (62% in business 16 years or more)
Retail companies (81% of retail companies have computers)	Industry	Manufacturing companies (66% of manufacturing companies have computers)
69% have college degrees	Education	44% have college degrees
Average increase in revenues 4.5%, profits 2.9%, and employment 1.8%	Growth	Average increase in revenues 2%, profits 1.7%, and employment .3%
30% export, 19% import	Trade	15% export, 12% import
72% plan to invest in employee training next year	Training	48% plan to invest in employee training next year
38% improved productivity in last 12 months	Productivity	10% improved productivity in last 12 months
81% changed the way they do business in the last 12 months	Change	42% changed the way they do business in the last 12 months

Use of Outsourcing

Percentage of respondents indicating the following applies to them

Nearly two-thirds of small and mid-sized businesses have outsourced operations to outside suppliers.



Operations Outsourced

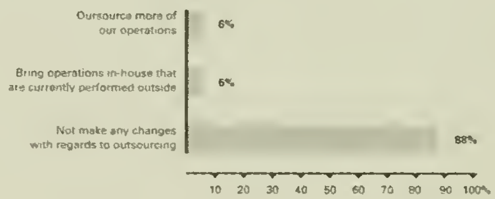
Percentage of respondents that have outsourced the following operations

The most common operations for small and mid-sized business to outsource include: accounting, payroll processing, benefits/insurance and delivery/distribution. However, no single operation was outsourced by more than one-third of businesses responding.

Plans to Outsource

Percentage of respondents planning the following changes in the next 12 months with regard to outsourcing

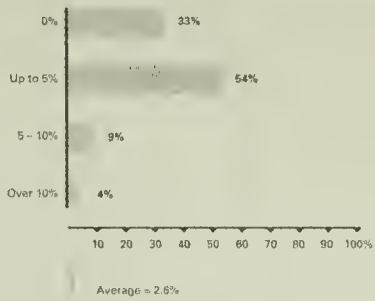
The majority, 88%, of small and mid-sized businesses do not plan to increase or decrease their use of outsourcing.



Business Investments - Training

Percentage of respondents planning to invest the following percentages of revenue in the next 12 months

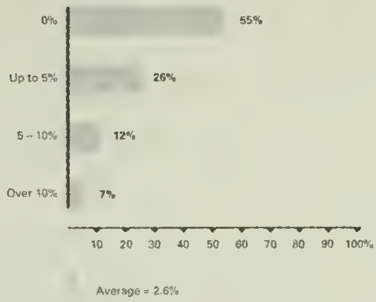
Small and mid-sized businesses plan to spend an average of 2.6% of revenues on training in the next 12 months.



Business Investments - R&D

Percentage of respondents planning to invest the following percentages of revenue in the next 12 months

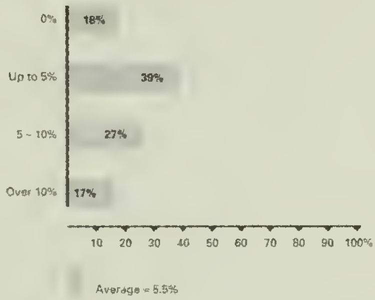
Small and mid-sized businesses plan to spend an average of 2.6% of revenues on research and development in the next 12 months.



Business Investments - Marketing

Percentage of respondents planning to invest the following percentages of revenue in the next 12 months

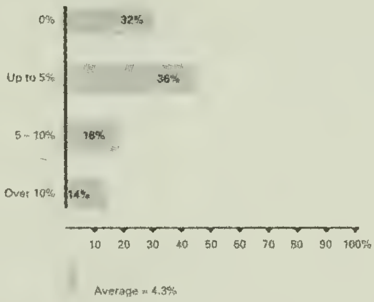
Small and mid-sized businesses plan to spend an average of 5.5% of revenues on marketing in the next 12 months.



Business Investments - New Technology

Percentage of respondents planning to invest the following percentages of revenue in the next 12 months

Small and mid-sized businesses plan to spend an average of 4.3% of revenues on new technology in the next 12 months.



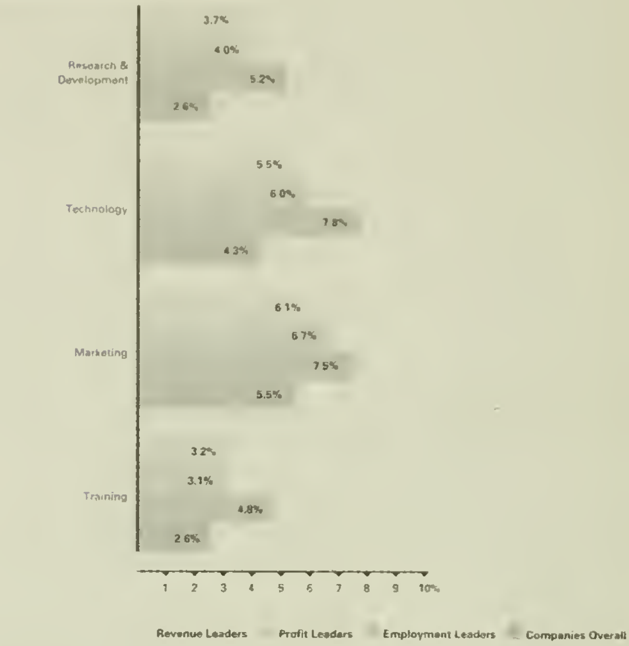
Fast Growing Companies

The following section examines several attributes of the survey's growth leaders. Growth was captured by measuring reported increases in revenues, profits and employees. Leaders represent those companies who increased the measure by 10% or more over the last 12 months.

Invest for the Future

Percentage of revenues invested in each of the following areas

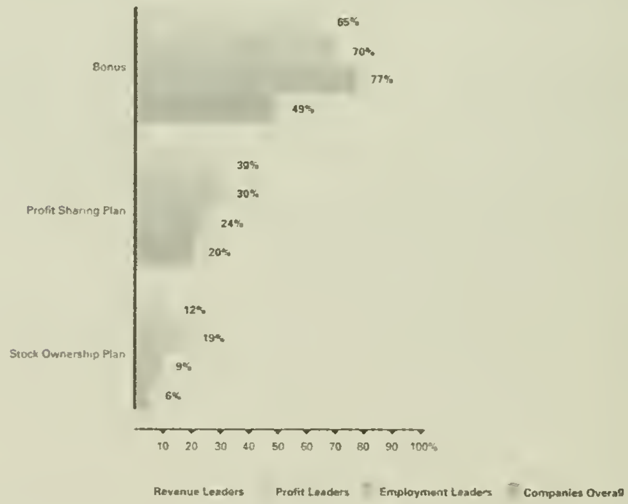
The small and mid-sized businesses that grew the fastest during the past 12 months are planning larger than average investments in R&D, marketing, training and new technology. Particularly high were investments by the employment leaders, those companies that expanded their workforce by 10% or more.



Pay for Performance

Percentage of respondents offering the following benefits to their employees

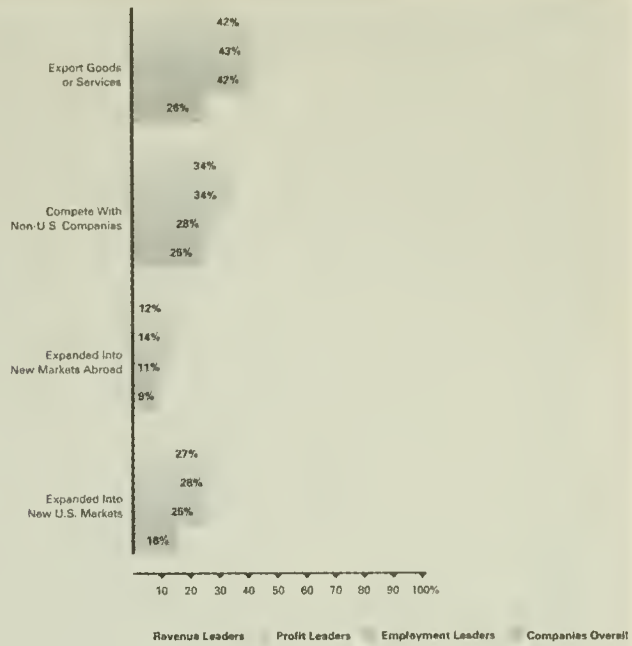
This year's growth leaders were significantly more likely than average to offer their employees profit-sharing, bonuses and stock options as part of their benefit package.



Reaching Out to New Markets

Percentage of respondents indicating the following

Growth leaders were significantly more likely than average small and mid-sized businesses to export goods or services, compete with non-U.S. companies, expand into new markets abroad and expand into new U.S. markets during the last 12 months.

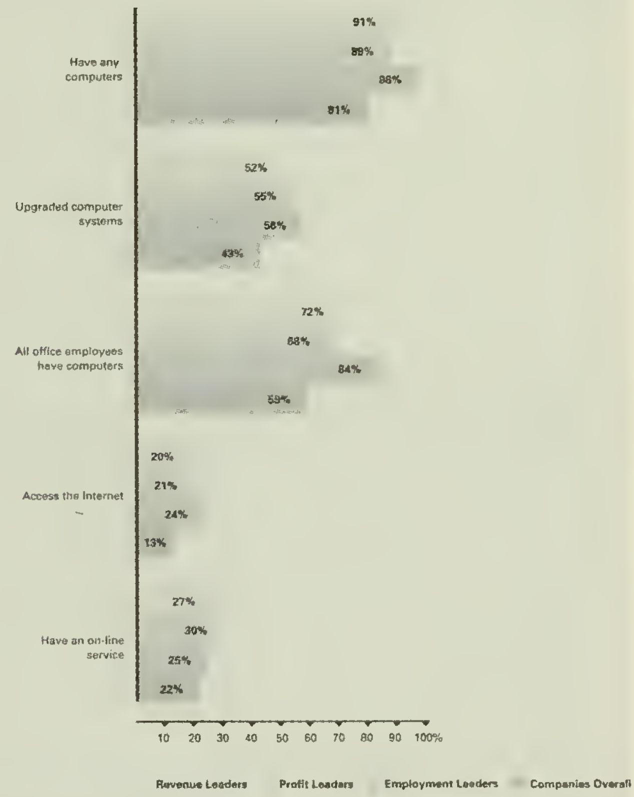


Compete with Technology

Percentage of respondents who indicated the following uses of technology

Only 2% of companies that increased their workforce by 10% or more last year did not use computers, compared to 19% of all companies surveyed.

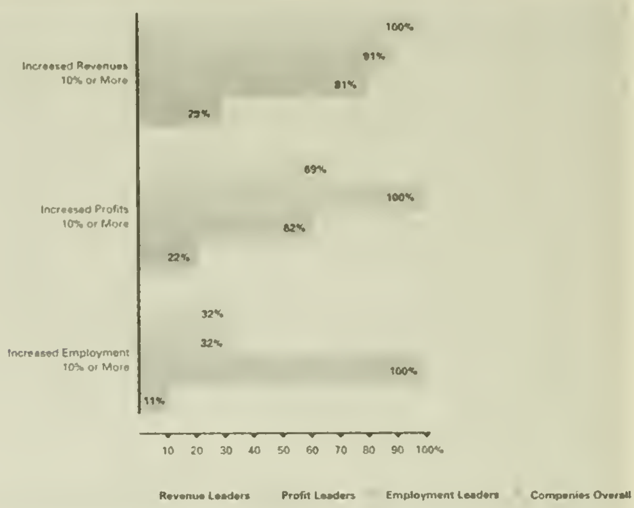
Overall, fast-growing companies were more likely than average to have computers, upgrade their computer systems, access the Internet and use an on-line service.



Types of Growth

Percentage of respondents indicating the following increases over the last 12 months

This chart shows the relationships between the different types of growth. For example, if a company was a profit leader (profits up 10% or more), it is highly likely that it also was a revenue leader (revenues up 10% or more).



Summary of Characteristics for Fast-Growing Companies

Characteristics of companies whose revenues grew by 10% or more over the last 12 months

Fast Growing Companies	Attribute	Companies Overall
Average 32 employees	Size	Average 22 employees
Located particularly in North Central	Region	Located nationwide
42% export, 26% import	Trade	26% export, 17% import
Expect revenues to increase 9.5%, profits 7.5% and employment 4.0%	Optimism	Expect revenues to increase 6.4%, profits 4.8% and employment 1.8%
34% cite lack of qualified workers among most significant challenges	Challenges	25% cite lack of qualified workers among most significant challenges
89% changed the way they do business in the last 12 months	Changes	74% changed the way they do business in the last 12 months
91% have computers, 27% subscribe to on-line services, and 20% access the internet	Technology	81% have computers, 22% subscribe to on-line services, and 13% access the internet
Invest 3.2% of revenues in training, 3.7% in R&D, 6.1% in marketing, 5.5% in new technology	Invest for Future	Invest 2.6% of revenues in training, 2.6% in R&D, 5.5% in marketing, 4.3% in new technology
Offer more of all benefits, in particular, 65% offer bonuses, 30% profit-sharing, and 12% ESOPs	Benefits	Offer less of all benefits, in particular, 49% offer bonuses, 20% profit-sharing, and 6% ESOPs
83% were able to obtain adequate financing, 92% successful in getting bank loans	Financing	77% were able to obtain adequate financing, 85% successful in getting bank loans

Financing

Types of Financing Used

Percentage of respondents using the following types of financing to meet their capital needs during the last 12 months

Commercial bank loans, earnings of the business and credits cards were the top-three types of financing used by small and mid-sized businesses to meet their capital needs during the past 12 months.

Credit cards remain a popular form of accessing needed funds – though this form of financing is predominantly used by the smaller companies (0-19 employees). (See chart on the next page.)

Nearly one in three did not use outside financing this year.

Types of Financing by Size

Percentage of respondents using the following types of financing to meet their capital needs during the last 12 months

The larger businesses in the survey were significantly more likely to use bank loans, earnings of the business and leasing than their smaller counterparts.

Smaller companies, however, were significantly more likely to use credit cards, private loans, personal bank loans or no financing at all.

	0 - 19	20 - 99	100 - 499
Commercial bank loan	36%	68%	70%
Earnings of the business	24%	39%	44%
Credit cards	27%	12%	5%
Private loans	18%	9%	7%
Personal bank loan	17%	6%	3%
Vendor credit	14%	16%	13%
Leasing	10%	22%	25%
SBA guaranteed loan	3%	8%	3%
Private placement of stock	3%	3%	5%
Selling/pledging accounts receivable	1%	6%	11%
Venture capital	1.5%	1.8%	2.2%
Public issuance of stock	2%	.6%	1.3%
Other	4.4%	2.4%	5.8%
Used no financing	30%	18%	15%

What's Different This Year

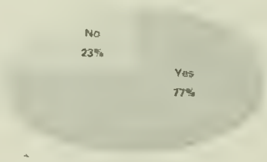
Percentage of respondents who used the following types of financing to meet capital needs during the last 12 months

	1993	1994	1995
Used no financing	24%	20%	29%
Earnings of the business	31%	36%	26%
Private loan	21%	21%	17%
Vendor credit	17%	17%	14%
SBA guaranteed loan	1.7%	1.6%	3%
Private placement of stock	.4%	1.5%	2.8%
Public issuance of stock	.1%	1.3$	4%

Ability to Obtain Adequate Financing

Percentage of respondents who were able to obtain adequate financing for their business

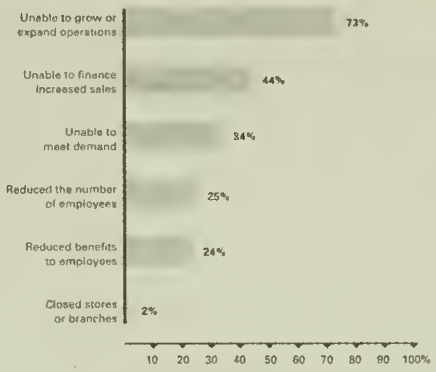
Just over three-quarters of small and mid-sized businesses said that they were able to obtain adequate financing in the last 12 months.



Effects of Inadequate Financing

Of those respondents who reported a shortage of capital, percentage reporting the following effects

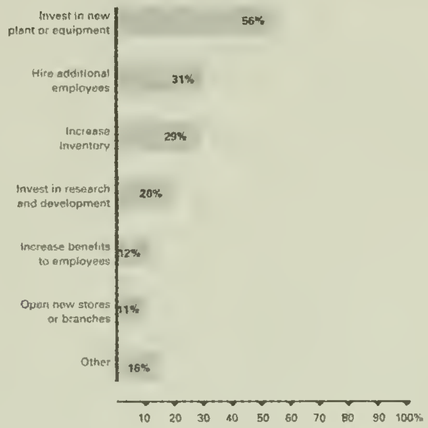
However, the 23% of small and mid-sized businesses that were unable to obtain adequate financing found it difficult to expand their operations and increase sales (among other things).



Most Common Uses of Capital

Percentage of respondents who indicated they used (or would use) capital in the following ways

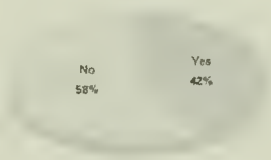
How do small and mid-sized businesses use the capital they can secure. The most common use is to invest in new plant and equipment. Other investments include employees, inventory and R&D.



Bank Loan Applications

Percentage of respondents who applied for a bank loan in the last 12 months

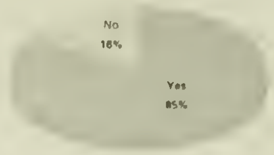
Forty-two percent of small and mid-sized businesses responding to the survey applied for a bank loan within the last 12 months - similar to the number applying the last few years.



Successful at Obtaining a Bank Loan?

Of those that applied, percentage of respondents who were successful at obtaining a bank loan in the last 12 months

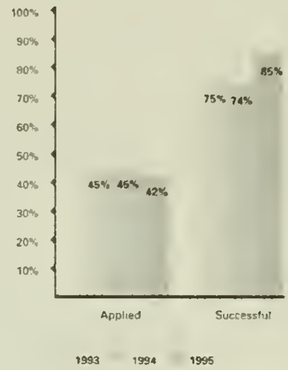
Eighty five percent of small and mid sized businesses that applied for bank loans within the last 12 months were successful at obtaining them.



Improved Access to Bank Loans

Of those that applied, percentage of respondents who were successful at obtaining bank loans

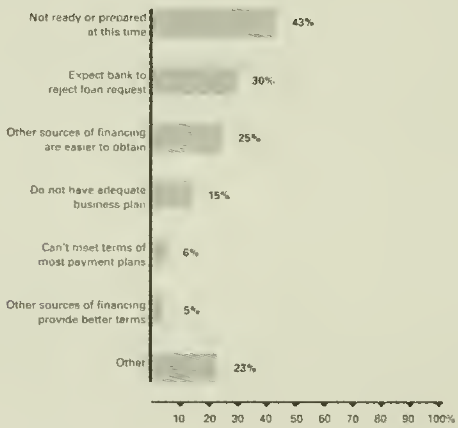
More small and mid-sized businesses were successful in obtaining loans this year. In fact, there was an increase of 11 percentage points in the number of companies successful this year compared to last year.



Why We Didn't Apply

Percentage of respondents who indicated the following reasons for not applying for a bank loan

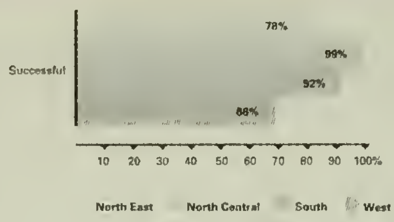
Most of the companies that didn't apply for bank loans simply didn't need additional financing within the last 12 months. However, among those that were short funds, 43% were not ready or prepared at this time, 30% expected the bank to reject their loan request, and 25% thought other sources of financing were easier to obtain.



Loan Success by Region

Of those who applied, percentage of respondents who were successful at obtaining bank loans

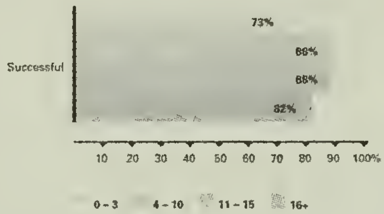
Nearly all (99%) of the small and mid-sized businesses located in the North Central region of the United States that applied for bank loans were successful in obtaining them. On the other hand, only 68% of companies in the West were successful.



Loan Success by Years in Business

Of those who applied, percentage of respondents who were successful at obtaining bank loans

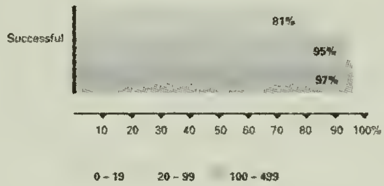
Start-ups, companies in their first three years of existence, encountered the most difficulty in obtaining loans. Still, nearly three-quarters of these businesses were successful during the last 12 months.



Loan Success by Size

Of those who applied, percentage of respondents who were successful at obtaining bank loans

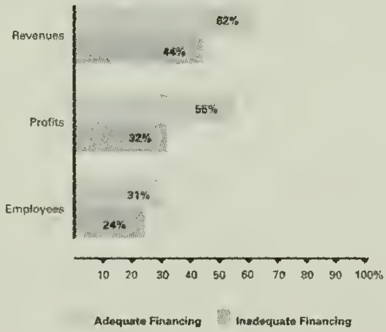
The larger the company the more likely it was successful at obtaining a bank loan. Ninety-seven percent of companies with 100-499 employees that applied for bank loans in the last 12 months got them.



Financing and Percent Realizing Growth

Percentage of respondents indicating an increase in revenues, profits and employees over the last 12 months

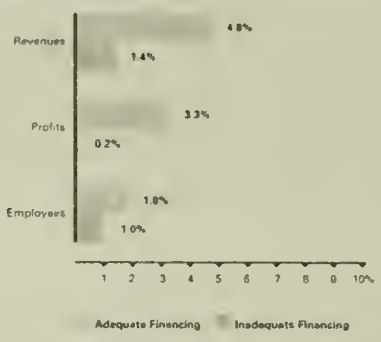
Small and mid-sized businesses that obtained adequate financing were significantly more likely to report increases in revenues, profits and employees over the last 12 months than those with inadequate financing.



Financing and Actual Growth Rate

Percentage change in revenues, profits and employees over the last 12 months

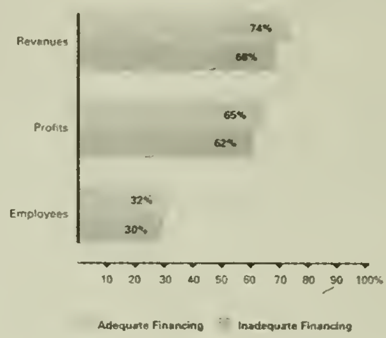
Small and mid-sized businesses that obtained adequate financing reported significantly higher levels of growth over the last 12 months than those with inadequate financing. For example, the average percentage increase in revenues among adequately-financed companies was 4.8%, more than three times that of inadequately-financed companies (1.4%).



Financing and Percent Expecting Growth

Percentage of respondents who expect an increase in revenues, profits and employees over the next 12 months

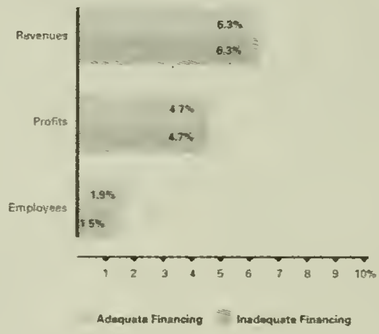
Despite being significantly less likely to have reported an increase in revenues, profits or employees, inadequately-financed companies are nearly as optimistic about growth over the next 12 months as are their adequately-financed counterparts.



Financing and Expected Growth Rate

Expected percentage change in revenues, profits and employees over the next 12 months

Despite recording lower levels of growth, inadequately-financed companies expect about the same level of growth over the next 12 months as do their adequately-financed counterparts.

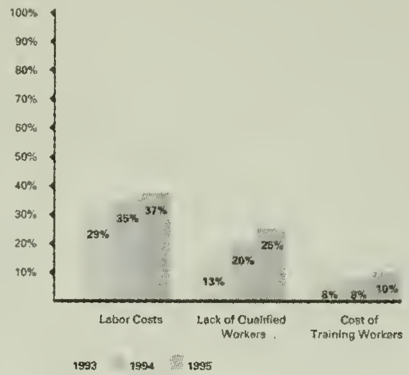


Labor Issues/ Health Care

The Growing Labor Challenge

Percentage of respondents who indicated the following are among the three most significant challenges to the future growth and survival of their business

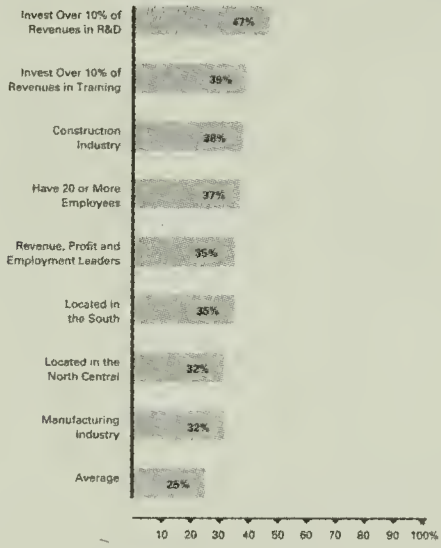
Small and mid-sized businesses were asked to select the most significant challenges to their future growth and survival. Only three challenges have grown increasingly important each year since 1993. They include: labor costs, lack of qualified workers and the cost of training workers.



Those Most Concerned with Worker Quality

Percentage of respondents who indicated "lack of qualified workers" was among their three most significant challenges to the future growth and survival of their business

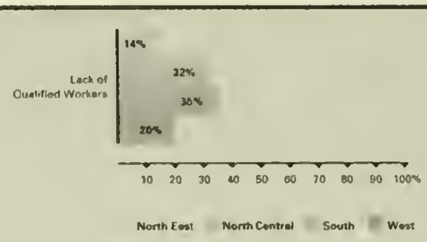
The companies that were most likely to report "lack of qualified workers" as one of their most significant challenges include those listed in the chart to the right.



Labor Challenges by Region

Percentage of respondents who indicated the following are among the three most significant challenges to the future growth and survival of their business

Companies in the North Central and South were more likely to cite "lack of qualified workers" as one of their most significant challenges. Not incidentally, companies in these regions also are more likely to expect an increase in their workforce in the next 12 months.

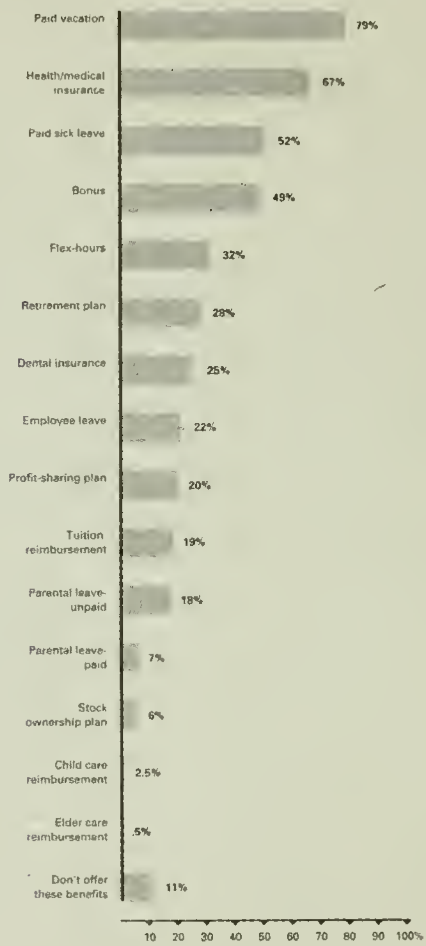


Benefits Offered

Percentage of respondents offering the following benefits to their employees

Paid vacation and health/medical insurance were the two benefits offered by a majority of small and mid-sized businesses.

Eleven percent of the small and mid-sized businesses responding to this survey don't offer any of the benefits listed to the right.



Benefits Offered by Size

Percentage of respondents offering the following benefits to their employees

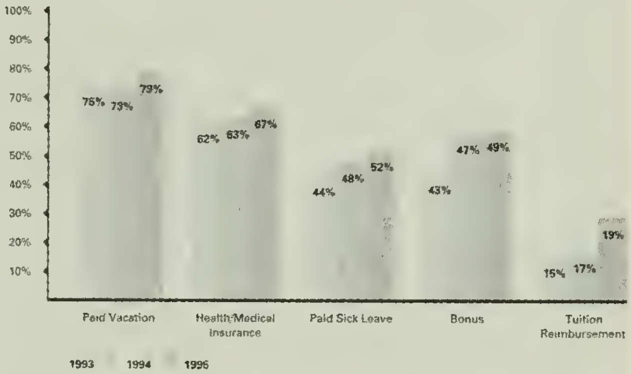
Overall, the larger businesses in the survey were more likely to offer the benefits listed in the chart on the right. An exception, smaller businesses (0-19 employees) were more likely to offer flex-hours.

	0 – 19	20 – 99	100 – 499
Paid vacation	77%	97%	99%
Health/medical insurance	62%	95%	98%
Paid sick leave	49%	64%	77%
Bonus	45%	64%	72%
Flex-hours	32%	27%	28%
Retirement plan	21%	53%	70%
Dental insurance	20%	48%	65%
Employee leave	19%	34%	44%
Profit-sharing plan	15%	46%	48%
Tuition reimbursement	15%	32%	60%
Parental leave – unpaid	13%	47%	58%
Parental leave – paid	6%	10%	16%
Stock ownership plan	5%	9%	17%
Child care reimbursement	2.4%	3.5%	5.3%
Elder care reimbursement	.60%	.30%	.40%
Don't offer these benefits	13%	.30%	0.0%

Benefits Growing in Popularity

Percentage of respondents offering the following benefits to their employees

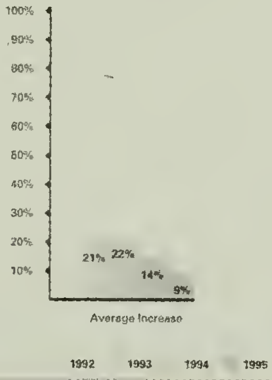
Compared to previous years, more small and mid-sized businesses offered paid vacation, health/medical insurance, paid sick leave, bonuses and tuition reimbursement over the last 12 months.



Flattening the Health Care Spiral

Average percentage increase in health care costs

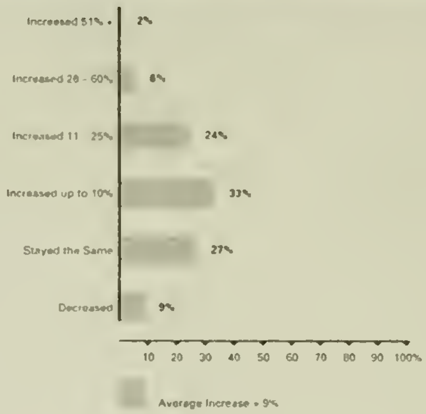
Though still significantly above the rate of inflation, the average increase in health care costs experienced by small and mid-sized businesses has dropped considerably over the last three years.



The Cost of Health Care

Percentage of respondents providing health insurance that reported the following increases in their health care insurance costs last year

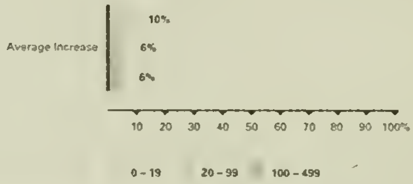
The majority of small and mid-sized businesses (92%) that provide health care insurance experienced less than a 25% increase in their costs over the last 12 months. The average increase was 9%.



The Cost of Health Care By Size

Average percentage increase in health care costs

Smaller businesses (0–19 employees), on average, experienced larger increases in their health care insurance costs.



Managing Health Care Costs

Percentage of respondents providing health insurance that made the following changes within the last 12 months

Small and mid-sized businesses have taken a number of steps to keep their health care insurance costs in check. Like last year, the most popular step was to change insurance companies.

Overall, small and mid-sized businesses are making fewer changes this year. However, more are instituting managed care than in the past.

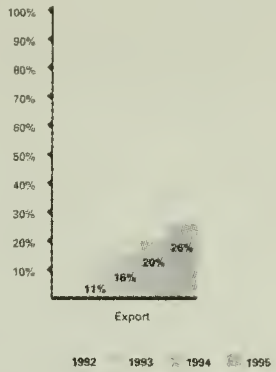
	1993	1994	1995
Changed insurance company	22%	40%	21%
Changed to policy with higher deductible	31%	36%	18%
Switched to HMO or PPO plans	12%	26%	14%
Changed to policy with higher co-payments	19%	22%	13%
Instituted managed care	3%	2%	9%
Increased employee's contribution	17%	25%	9%
Reduced benefits offered	15%	16%	7%
Dropped coverage	7%	4%	4%
Switched to cafeteria-style program	2%	6%	3%
Switched to full/partial self-insured	6%	9%	3%
Instituted wellness programs	5%	9%	2%
Other	14%	8%	4%
Have not made any changes	NA	NA	47%

International Trade

Businesses that Export

Percentage of respondents who export goods or services

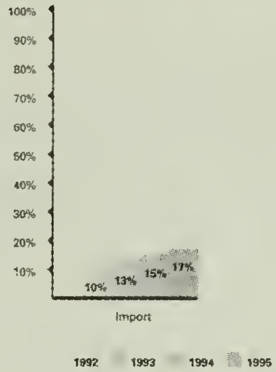
About one in four small and mid-sized businesses export goods and services. The percentage of businesses exporting has steadily increased over the last four years, more than doubling since 1992.



Businesses that Import

Percentage of respondents who import goods or services

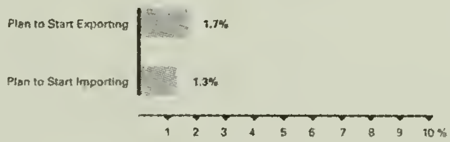
About one in six small and mid-sized businesses import goods and services. The percentage of businesses importing has steadily increased over the last four years, but not to the extent that exporting has increased.



Plans to Increase Trade

Percentage of respondents who plan to start trading goods or services abroad in the next 12 months

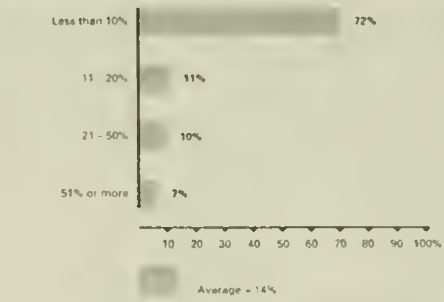
Over the next 12 months, 1.7% of small and mid-sized businesses plan to start exporting for the first time and 1.3% plan to start importing.



Revenues from Trade

Percentage of respondents who earned the following revenues from exported goods or services

Of those small and mid-sized businesses that export, the vast majority earn less than 10% of their revenues from exported goods or services. On average, 14% of revenues come from exports for these companies.



Most Popular Markets

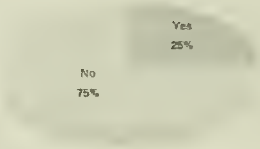
Percentage of respondents doing business in the following markets

Outside the U.S., the most common markets for small and mid-sized businesses to conduct business in are Canada, Europe and Asia/Pacific. About 10% currently are doing business in Mexico.

Global Competition

Percentage of respondents who indicate they directly compete against non-U.S. companies

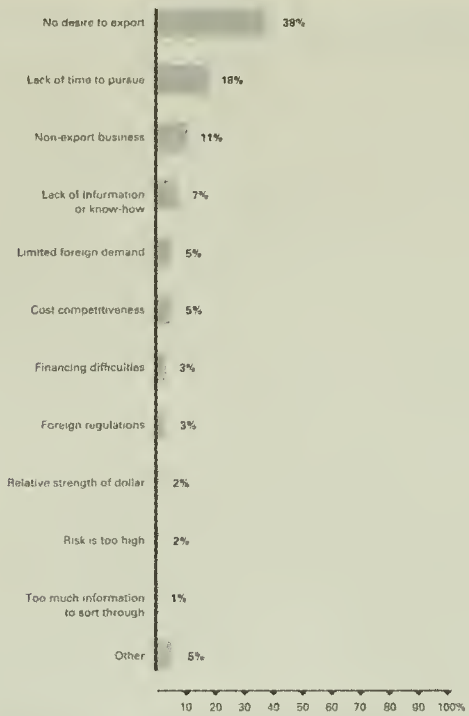
One-quarter of small and mid-sized businesses indicated that they face direct competition from non-U.S. companies.



Why Not Go Global?

Percentage of respondents indicating the following as their most significant barrier to starting or expanding export sales

The most common reason for small and mid-sized businesses not to export is a lack of desire followed by a lack of time to pursue and the belief that they run a non-export business.



Characteristics of Exporters

Profile of respondents who indicated they export goods or services

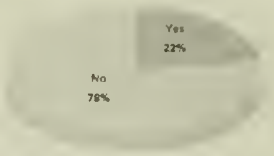
Companies that Export	Attribute	Companies Overall
Average 37 employees	Size	Average 22 employees
45% are in manufacturing industry	Industry	29% are in manufacturing industry
78% are college degreed	Education	65% are college degreed
44% import goods or services	Trade	17% import goods or services
Average increase of 6.7% in revenues, 4.3% in profits and 2.7% in employment	Growth	Average increase of 4.0% in revenues, 2.6% in profits and 1.6% in employment
Expect 8.3% increase in revenues, 6.6% in profits and 2.7% in employment	Optimism	Expect 6.4% increase in revenues, 4.8% in profits and 1.8% in employment
36% cite lack of available capital among most significant challenges	Challenges	24% cite lack of available capital among most significant challenges
88% changed the way they do business in the last 12 months	Change	74% changed the way they do business in the last 12 months

Government Policies

Minimum Wage Employees

Percentage of respondents who employ minimum wage workers

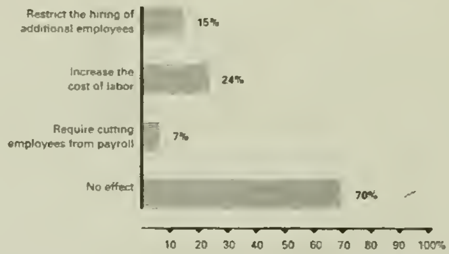
Twenty-two percent of small and mid-sized businesses reported that they employ minimum-wage workers.



Impact of Raising Minimum Wage

Percentage of respondents who indicated a $.90 increase in minimum wage will affect their business

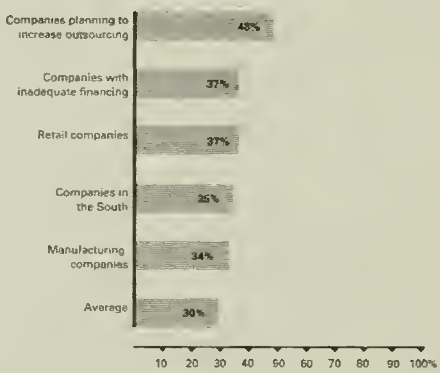
Seventy percent indicate that raising minimum-wage would have no effect on their business. This is no surprise given the finding that only 22% employed minimum-wage workers. The most common effect includes raising labor costs.



Most Likely to be Affected

Percentage of respondents who indicated a $.90 increase in minimum wage will affect their business

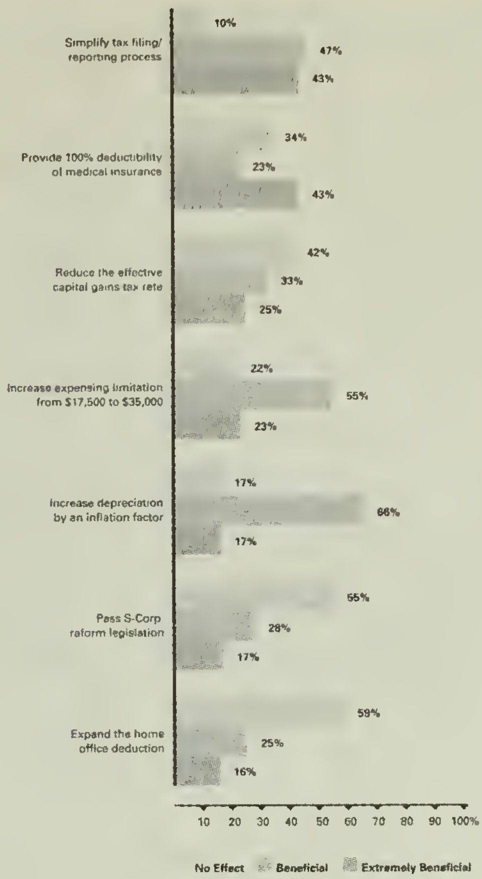
These small and mid-sized businesses were more likely than average to be impacted (in any way) by an increased minimum-wage.



Tax Policy Views

Percentage of respondents indicating the following level of benefit for these tax provisions

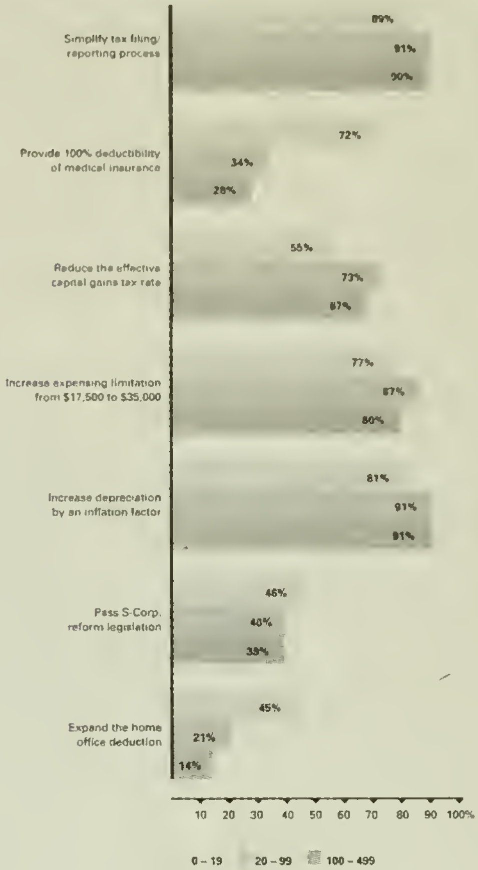
Small and mid-sized businesses were most likely to believe that, of several tax reforms currently under debate, simplifying the tax filing/reporting process would be the most beneficial.



Tax Policy Views by Size

Percentage of respondents indicating the following tax provisions were beneficial or extremely beneficial

While all companies surveyed agreed on the importance of simplifying the tax filing/reporting process, in other areas, there were some major differences by size. In particular, smaller companies voted more heavily for the deductibility of medical insurance for the self-employed and expanding the home office deduction.

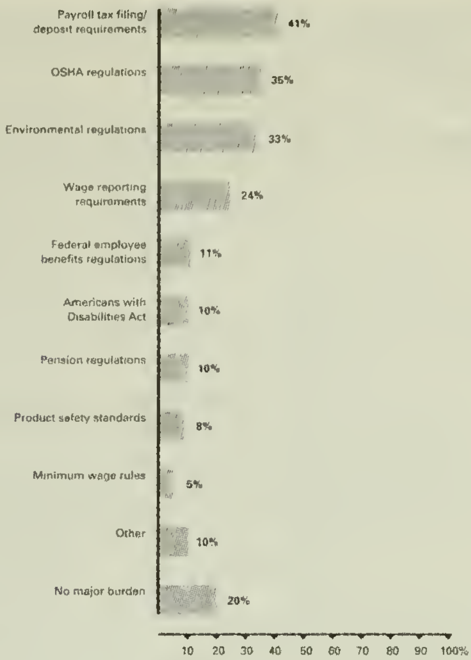


Government Regulations

Percentage of respondents indicating the following regulations are among the three most burdensome to their business

Given their views about simplifying the tax filing/reporting process, it's no surprise that payroll tax filing/deposit requirements are listed as the most burdensome government regulation for small and mid-sized businesses.

Also, more than one-third of the businesses responding to this survey cited OSHA regulations and environmental regulations are among the most significant regulatory burdens to their business.



About Arthur Andersen's Enterprise Group

Arthur Andersen's Enterprise Group focuses on improving the growth and competitiveness of middle-market businesses through the delivery of business advisory, audit and tax services.

Enterprise Group professionals provide objective insight to growing companies and to their owners, during all stages of the company's development – from start-up to maturity. We develop a personal knowledge of the client's business to improve the company's performance, efficiency and value.

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We provide a full range of services to meet your business needs:

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About NSBU

National Small Business United is a private, nonprofit association representing more than 65,000 small-business owners throughout the United States. NSBU members represent all 50 states and all service and industrial sectors. In addition to individuals. NSBU members include local, state, regional and national organizations and NSBU state chapters.

NSBU's mission is to advocate on the federal level. The association takes a non-partisan approach when working with Congress and elected and appointed officials. Through this constructive engagement, NSBU strives to improve the economic environment for small-business growth and survival.

NSBU has a strong history of fostering grassroots activism by empowering small-business owners to become small-business activists. The 32-member volunteer board of trustees meets throughout the year to set policies and direct the Washington, D.C.-based staff.

Each year, NSBU's Fall Federal Issues Retreat provides a forum for small-business leaders to discuss legislative priorities. Each spring, members present legislative recommendations to Congress and the administration during the NSBU Washington Presentation, a grassroots lobbying event that began in the 1940s. Throughout the year, members testify in Congress about critical issues affecting small business.

As the nation's oldest small-business association, NSBU was largely responsible for initiating the first White House Conference on Small Business.

In June 1995, NSBU expressed the concerns of small-business owners to Congress and the Clinton Administration at the White House Conference on Small Business (WHCSB). The 2,000 conference delegates, small-business owners from nationwide, handed a list of 60 action-items deemed most important to the small business community. NSBU delegates had by far the greatest influence over the agenda having recommended a total of 41 items. In fact, eight out of the top-ten vote-getters were NSBU issues! Among NSBU recommendations that made the final 60 were:

- Health Care Reform: Long recommended by NSBU, this issue received the fifth-highest number of votes. Delegates strongly encouraged Congress to pass health care reform, which permits voluntary community health-purchasing cooperatives.
- Regulatory Flexibility Act: Ranking as the third-highest recommendation, delegates suggested that the REF require a cost-benefit analysis along with judicial review of regulations.
- Small Business Administration: A long-time NSBU issue, conference delegates listed strengthening the SBA as a top-priority, ranking in the top 20.
- Superfund: As the fifth-highest vote-getter at the conference, delegates recommended a nine-step process to help reform this program.

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NSBU: Not a special interest... a clear path for the common interest.

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COMMENTARY

SECTION C
SUNDAY, FEBRUARY 25, 1990

Banks' interest in customers dips as banks rack up profits

By PETER B. PACH

For the fifth time in my two decades of Connecticut banking, my worldly fortune has shifted hands.

I know this because a few weeks ago I received an expensive-looking brochure in the mail. "Welcome to your bank," its cover said in a way that was declarative more than inviting.

I had, until that moment, been doing business with Shawmut Bank. But, in a banking merger deal that shifted billions of dollars to the benefit of stockholders and some lucky insiders, ~~I was sold to Webster Bank.~~

Only a few years ago, I was sold to Shawmut by Connecticut National Bank, which had acquired me from Shawmut / Home Bank. My money began its odyssey in the Meriden-based Home Bank, where everyone from the tellers to president greeted me by name.

Now, a few keystrokes during the recent Presidents' Day weekend moved me once again from one computer to another — a fiscal pebble tossed unnoticed in the greater seismic shifting along New England's financial fault lines.

Nobody asked me.

Of course, nobody asked anybody in Connecticut. Market forces — a desire for higher profits — led officials of Fleet Financial Group and Shawmut National Corp. to merge. Attorney General Richard Blumenthal touted his role in forcing the two Boston-based financial giants to sell off some of their Connecticut assets to Webster and three other banks. He was concerned that the state keep some sense of local community-based banking.

So, I'm left with the warmly worded promotional mailing from Webster Bank, ~~take it or leave it.~~ I don't know whether to be comforted or alarmed by Webster's $4 billion in assets. The bank's holdings apparently qualify as small enough to be homey. But banking analysts see Webster as a prime candidate for takeover by a larger regional bank looking to buy some Connecticut roots.

Either way, my holdings are of little account even in this relatively smaller bank. I am no longer a customer. I am part of a salable assets package.

~~My sense of community banking disappeared~~ about the time banks began to charge customers for the honor of depositing money. I would tell you that years ago one of my banks sent me new checks for free. This seems so incredible now that I begin to doubt my memory. I do know that banks used to pay interest worth getting on savings accounts and didn't

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Peter B. Pach writes editorials for The Courant.

Banks' interest in customers dips as banks rack up profits

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levy a service charge on customers too poor to maintain a minumum balance.

I am, despite what you might hear from my friends, largely resigned to the impersonal speed of modern times. But, when it comes to money, I am still among those who are tempted to bite a coin to test its worth.

From the day I first trusted a bank with my sack of pennies, nickels, dimes and quarters and accepted a passbook as documentation of my claim to ownership, I have been wary. Now, with electronic deposit of paychecks, money has become theoretical rather than physical. The satisfying feeling of cashing a paycheck and taking some money for spending is missing. Money is no longer safely stored in vaults. It is locked in computer chips.

Banks, which once placed a premium on imposing-looking front doors, vast lobbies, barred tellers' windows and the always visible heavy safe doors, would prefer that customers stay away. From the days of towering marble pillars on a town's most prominent street, banks have become vending machines tucked into shopping malls or housed in tiny vestibules that could double as cheap bus shelters.

The same marketing teams that welcomed me to my new bank must have been the ones hired to celebrate the first teller machines. The automatic tellers were a new customer service, we were told, and they saved banks money. The cash machines work 24 hours a day without pay or benefits. They don't slow down business by asking customers about their kids or complimenting them on a new tie.

Bank officials quickly forgot about the money they saved with their cash machines and introduced transaction fees. The automatic tellers became just another way to nick depositors for wanting their own money.

Even as my money has wandered the fiscal highway, I have refused to get a bank card. I like at least the sense that real people handle and even care about my savings and checking accounts. I will continue to seek out real tellers who count my money twice and frequently wish me a nice day. Human tellers don't charge for making withdrawals and deposits — at least they didn't at my old bank.

TODAY'S NEWS

TUESDAY, AUGUST 15, 1995 New Haven Register SECTION D

WORKING SMARTER Organize your day to get more done, **Page D6**

COMPARING RATES Where to find deals on loans, CDs, **Page D14**

STOCKS, PAGE B7	DOW UP 41.56	GOLD UP $0.00	OIL DOWN $0.33
CLOSE:	4,659.86	$384.10	$17.48

BUSINESSEXTRA

'Non-bank banks' on the rise

Firms offer creative lending solutions

By Chris Capot
Register Staff

Kevin S. Tierney and Penn Ritter see themselves as pioneers cutting a swath through Connecticut's financial prairie.

Tierney and Ritter run companies that are known as "non-bank banks," which are firms that don't take deposits but still lend to businesses, like banks do.

Or, Tierney and Ritter say, like banks *should* do.

Tierney runs Connecticut Business Credit Inc. in Branford, and Ritter operates Business Lenders Inc. in Hartford. They believe their firms are acting more like banks once did: Giving companies a leg up in bad times.

These companies say they've found a significant niche in Connecticut's depressed economy by providing creative lending solutions that traditional banks are not attempting.

"What I have found is that companies with sales under about $5 million a year, whose borrowing needs are under about $2 million — which is probably about 90 percent of most businesses in Connecticut — are in many ways like nomads wandering the Connecticut landscape, trying to find lenders that understand them," said Tierney, a 47-year-old veteran banker.

"We're filling the void," he said.

Marc Lovett/Register

From left, Connecticut Ventures' Peter Curtis, Bob Mahoney and President Kevin Tierney get news on a deal.

The differences: While most bankers believe the number of "non-bank banks" is on the rise nationally, the number of traditional banks is waning.

According to the Connecticut Bankers Association and the Federal Reserve Bank of Boston, no good data exists on the number of non-bank institutions in the country. That's because most are unregulated or are regulated by a variety of government agencies, from the Securities and Exchange Commission to the Federal Trade Commission and, sometimes, state banking departments.

Generally an institution is subject to federal and state banking regulations if it holds deposits and uses them to make loans.

The number of traditional banks in the country has fallen from 11,000 in the mid-1980s to about 8,000 today, according to the CBA.

The five New England states had 758 banks in 1985, but only 510 in 1994, according to Susan Bannon, a resarcher at the Federal Reserve Bank of Boston.

Of course, the "non-bank banks" are not for every business, Tierney says. Money isn't free, and there's some risk.

"It's not a business for the weak of heart," Tierney said.

Typically, non-bank banks that specialize in commercial lending can deliver loans faster and for slightly lower interest rates than traditional banks.

COVER STORY

Also, non-bank banks are often staffed by veteran bankers who have commercial lending expertise but were victims of the consolidation in the banking industry.

Non-bank banks have the ability to package financing from secondary markets, like pension funds and venture capital firms, sources that banks don't seek out. Banks use federally insured deposit money, which is heavily regulated.

Most of the time, non-bank banks use commercial real estate as collateral for loans. The risk to borrowers is that they could lose that property if they default on the loan.

Brian Dreyer, senior vice president for commercial lending at People's Bank, said small-business investment companies, or SBICs, and commercial finance companies, of CFCs — other names for non-banks — are in a high-risk business. With assets of $6.5 billion, People's has the largest commercial banking portfolio of any Connecticut-based bank.

"Obviously banks are regulated lenders, by the federal government and state government. We're ethical

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NEW HAVEN REGISTER, TUESDAY, AUGUST 15, 1995

Alexion gets $100,000 for gene research

NEW HAVEN — Alexion Pharmaceuticals Inc. has received its second Phase 1 Small Business Innovation Research Grant for its in vivo gene therapy program, the company said Monday.

The $100,000 grant will go to Alexion senior scientist Russell Rother, the principle investigator, for further development of Alexion's proprietary immune-protected retroviral vector particles and producer cells, which are designed to be directly administered to patients for in vivo human gene therapy.

A report on Alexion's work in this area was published in the April issue of the journal Human Gene Therapy.

Retroviral-mediated gene transfer is employed in the majority of the more than 100 approved gene therapy trials. Despite the recent advances in the use of retroviral vectors for gene transfer, nearly all human gene therapy trials are limited to cumbersome ex vivo applications — transduction of autologous cells outside the body and subsequent administration of these engineered cells back to patients.

Slamming: States say companies should be liable

Continued from Page D3

certainly look at whatever the attorneys general have to say," said Kathleen Wallman, chief of the FCC's Common Carrier Bureau.

Slamming is the largest source of complaints at the FCC, accounting for more than 700 a month. Some states receive many more complaints, with Nevada logging more than 7,000 a month.

The states also want the FCC to require that promotional materials sent to prospective customers be separate from documents that would authorize a change in long-distance service.

Under the FCC's revised rules, the materials are supposed to be separate but companies are permitted some exceptions. They can, for example, use one long sheet where the authorization form may be separated by a perforated line.

The FCC's revised rules also let a company using a check as an inducement to also use it as the authorization form as long as this is made clear to consumers.

The states want the check and the authorization form to be separate. "People do not expect that they are signing a binding contract by cashing a check," Blumenthal said. "These are misleading promotions that benefit the long-distance companies, not consumers."

In addition, the states also want the FCC to require authorization forms to be in the same language as promotional materials.

Studies have shown that people whose primary language is not English are often victims of slammers.

It is illegal for a company to switch a person's long-distance service without permission. Under rules adopted in 1992, the FCC requires companies trying to woo customers by direct mail or other printed materials to obtain an authorization form signed by the customer before service may be legally switched.

For phone solicitations, the FCC requires long-distance companies to obtain confirmation that a switch has been authorized. They can do this by obtaining the consumer's written authorization or by getting oral authorization verified by an independent third party.

Besides Connecticut, the states seeking stronger rules are Arizona, Arkansas, California, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Jersey, New Mexico, North Carolina, Pennsylvania, Rhode Island, Tennessee, Vermont, West Virginia and Wisconsin.

Pensions: People need lessons on saving and investing, Feen says

Continued from Page D3

Americans, Feen said he suggested the council consider recommending that curriculum changes be made as early as in elementary school.

"We must educate children in the grammar and middle schools on the importance of savings so that they learn how banks work and how they can greatly improve their futures by putting aside allowances or whatever money they may earn or receive as gifts," Feen said.

In addition, the council will probably recommend that public high schools introduce personal finance courses.

"Otherwise they become adults and don't know what to do with money," he said.

A solution must also be found for the nation's high school dropout problem, Feen said, citing figures that show three out of four high school dropouts have no pension plans.

In comparison, two out of every three workers with college degrees work in jobs that do supply a pension.

Banks: These institutions step in where the traditional stop

Continued from Page D1

lenders, by the federal government and state government. We're ethical lenders, and we don't use what we used to call 'sharp business practices.' We also give back into the communities, with our people donating time and money to civic organizations, sponsoring events."

Dreyer said banks, in general, have to be much more responsible in their lending practices.

"We're not making high-risk loans, and if you need one, a non-bank bank is probably the place to go," Dreyer said.

Jerry Noonan, president of the Connecticut Bankers Association, said that banks are handcuffed by regulations that complicate lending to small businesses.

"I think the financial services industry is becoming so diverse that there's a place for a lot of people to go," Noonan said. "Our problem as banks is that these companies can pick away at the market. They don't have the regulatory controls we have."

Of course, where there's money to be made the big nationwide financing companies do swoop in to provide some competition for companies like Tierney's and Ritter's.

For instance, AT&T Capital opened an office for its AT&T Small Business Lending Corp. at 105 Sanford St. in Hamden in November 1994.

That office, staffed by Dave Sportelli, provides conventional loans, franchise loans and SBA-backed loans. AT&T Capital, the fifth largest SBA-licensed non-bank lender in the United States, provided over $92 million in loans in 1994.

Tierney's venture: Tierney describes himself and his company as a "financial intermediary."

From his office in Branford on East Main Street, Tierney and his colleagues at the several companies under the Connecticut Ventures LLC umbrella were busy servicing clients during a reporter's visit last week. Most people were on the phone. Others were either on their way in from talking with a client, or on their way out to meet one.

"I'm the link between sources of capital and those that need to borrow," Tierney said. "Banks aren't filling that role. They say they are, but they aren't."

Tierney has seen the Connecticut banking business from many sides, first with the former Hartford National Bank, then with the former Union Trust Co. and then Cititrust where he was in charge of problem loans.

Now, Connecticut Business Credit loans to every business, from start-up financings to complicated (or as Tierney calls them "exotic") real estate refinancings and everything in between.

Robert Parker, president of Fairfield Resources, a diversified company in Westport that's currently converting a sand and gravel company that it owns into a residential development company, also received some financial help from Connecticut Business Credit.

Although he wouldn't be specific about the financing, Parker did say that non-bank banks are the way to go for out-of-the-ordinary help.

"Traditional banks are on the way out," Parker said. "They put a lot of advertising out and say they're friendly to businesses, but the time when you need them they're not there. They talk the talk, but they don't walk the walk."

Whittlesey & Hadley, an accounting firm in Hartford, wanted to refinance a loan on its building at 147 Charter Oak Ave. The way a standard bank deal is structured, each of the firm's seven partners would have to guarantee the entire amount of the refinancing. To avoid that mess, the firm called Tierney.

Tierney was able to structure a deal that was better than a traditional bank refinancing because it allowed the partnership to guarantee the amount of the loan, so each partner was on the hook for only one-seventh of the refinancing.

"Most of the banks wouldn't do that," said Richard Pelletier, chief financial officer for Whittlesey & Hadley. "The term and the rate were better than the banks were offering, too."

Connecticut Business Credit has more than 70 commercial loans in the works, worth about $160 million, Tierney said.

Ritter's non-bank: For 13 years, Ritter, 40, was assistant House clerk and then House clerk at the General Assembly in Hartford. There he saw the need small businesses had for a non-bank lending institution, he recalled.

So he gathered some veteran loan officers, many of whom were victims of the consolidation in the banking industry, and started Business Lenders in November 1994.

"We're a bank in that our sole purpose is to fund small businesses," Ritter said. "We make business loans, that's all we do. We have lending officers, old-fashioned lending officers who deal with individual small-business owners on-site."

Ritter said Business Lenders Inc. now has about 15 employees and is the only non-bank SBA-lender of its size in Connecticut.

So far, the company has made more than 40 loans worth more than $10 million, and Ritter just added four more loan officers and expects very strong growth.

Claudia Behnke, 28, of Bethany, went to Tierney after her attempts to get loans at two traditional banks failed. She needed money to convert a building into a day-care center in Milford.

"We had a financial report for them but it was for something that hadn't started yet," said Behnke, who previously ran a home day care. "It looked nice on paper, but they wanted (more of a track record)."

After talking with Ritter, who visited her site on Oxford Road in Milford, she got her financing. Now, Behnke and her partner, Christina Dadario, plan to open Enchanted Forest Day Care Center later this month.

"We are extremely satisfied with the help they've given us," Behnke said. "It's been more of a friendship."

Ritter said the loan for Enchanted Forest in Milford was for $500,000.

Tom Hennessey, owner of Forbes Avenue Shell at 401 Forbes Ave. in New Haven, needed a loan for his businesses but was stopped at his bank.

"Thank God (Business Lenders)," Hennessey said. "I've been in business for about eight years and deposit about $1 million every year, and my bank looked at me like I had three heads when I asked them for a loan to buy this property.

"They wanted three forms of liquid assets before even considering it. If I had that I wouldn't need a loan," Hennessey said. "Business Lenders wrote us a loan through SBA."

Research and Publications

Small Business Research Awards for FY 1995 Announced

The Effect of Interstate Banking on Small Business Lending: Impact of the Banking and Branching Efficiency Act, P.L. 103-32. (Awarded to Joe Peek of Sharon, Massachusetts.) There are indications that many large acquiring banks have little interest in maintaining the historical lending relationships fostered by the smaller banks they acquire. This study will use a national panel of commercial and savings banks to estimate how consolidation in the banking industry may influence small business credit availability.

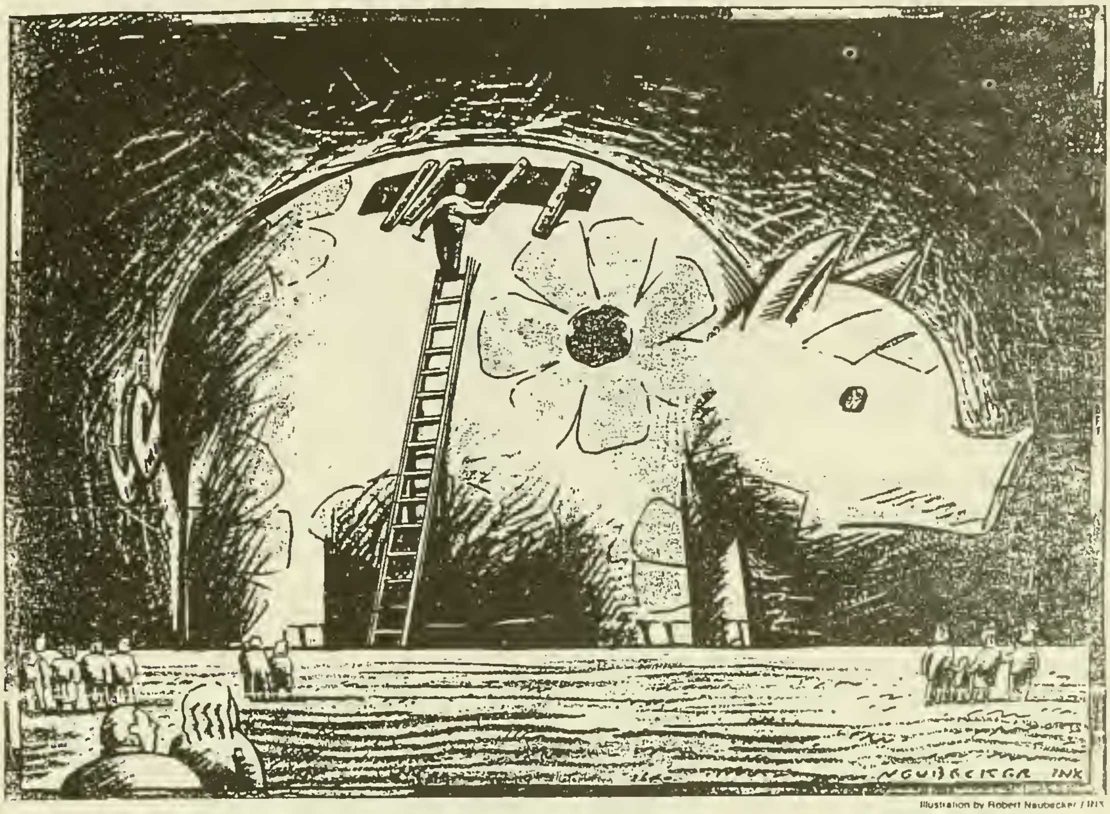


Illustration by Robert Neubecker / INX

The credit crunch — bank examiners stage an uprising

By ELIOT JANEWAY

Surprises again and again intrude upon the normal workings of the business cycle, reversing its course and its impact on the markets. Front-page headlines in The New York Times and The Wall Street Journal have disclosed that the country's lowly corps of bank examiners is busy preparing a big, bad surprise for the economy.

Federal Reserve Chairman Alan S. Greenspan let the cat out of the bag when he shilly-shallied about what the examiners were up to while he and his colleagues were doing nothing but talking. The Fed controls one set of national bank examiners, and the Department of the Treasury the other.

First, Greenspan told a congressional committee that banks were tightening credit despite the Fed's professed hesitation early this spring to take this risk in 1990's shaky economy. Then, he assured the news media that the Fed could find "little evidence" of a "credit crunch." Days later, he and fellow regulators made headlines by summoning the American Bankers Association to a private session at which they warned the banks "to avoid" the supposedly non-existent credit crunch.

Amid recriminations at the May budget summit, the Fed published its March minutes. The New York Times interpreted them as resolving to tighten credit after all because of "information" received that the economy, plainly weakening, was due to strengthen. The Wall Street Journal read them as refusing to nudge interest rates up because the credit crunch was already doing so. Take your pick.

The bank examiners themselves struck the only consistent note amid this bobbing and weaving. At their Chicago convention, they made no bones about having put a crunch on; and they announced their intention to tighten it.

Underlings routinely stage uprisings against their commanders in Third World dictatorships. America's trained army of bank examiners has just pulled one off against the country's duly constituted economic high command. They have exposed the economy to a credit crunch at a time when its leaders — beginning with the president himself — are admitting and spreading confusion over national economic prospects and options. Each alone would be upsetting to the marketplace. It cannot take both in stride.

Nevertheless, the country's economists have continued to take and to give comfort by promising a "soft-landing," which is econ-speak for the best of both worlds — victory over both inflation and recession. But they have an alibi for standing pat.

The fraternity divides into two groups of specialists. Those grading the performance of the economy count the official numbers; the policy watchers weigh official words. The statistics, always slow, have yet to record any evidence of distress spreading throughout the economy. Nor have the policy-makers sounded any alarms.

Bank examiners, after all, are administrative instruments of policy-makers, not makers of policy themselves. When they plunge into a policy vacuum, without directions or permission from their policy superiors, their muscular thinking is bound to precipitate chaos; and the policy-makers are already lamenting tell-tale signs of its onset witness the budget summit. The surprise is greatest among the economists, none of whom ever dreamed the bank examiners would rush in where their policy chiefs fear to tread.

The green-eye-shade boys, however, go by the rules in their manuals. Banks need capital to put loans on the books and keep them there; contrariwise, as banks lose capital, they must stop making new loans and start canceling old ones. Banks that can't make loans can't compete for deposits. No exceptions, just numbers. Never mind the consequences.

The consequences have entangled the

Please see Crackdown, Page D1

Janeway, publisher of The Janeway Letter, is author of The Economics of Chaos: On Revitalizing the American Economy. He wrote this article for The Baltimore Sun.

Crackdown on lending

Continued from Page D1

country's economic managers, including the president, in a war of words that precludes the remedial action that is clearly needed. Considering the remedies advocated by some of them, the predictable stalemate at the budget summit might have been a mercy if the examiners' policy chiefs had only made emergency arrangements to keep the machinery running as long as the sparring did.

The Fed and the Treasury could have instructed the examiners to ease the rules. Alternatively, they could have improvised temporary accommodation for banks smaller than the name banks qualified by size for bailouts. Instead, they invited the examiners to compound the admitted credit cost-squeeze of 1989 with the creeping credit-supply crunch of 1990. They showed no sensitivity to the ominous countdown, recorded in the Fed's own statistics, that the banks had just about lent out their deposits before the examiners cracked down on them.

The crackdown on lending, though directed at bank lenders, is victimizing bank borrowers in good standing, especially the smaller ones who account for most of the country's employment. It was their money that had been keeping endangered banks afloat. But now the chain reaction is shrinking deposits in banks labeled as shaky. Such broad concerns are not the responsibility of the examiners, at least in their present frame of mind. A Florida bank president quotes examiners threatening "to put bank lending officers in jail for making any more real-estate loans."

Yet more real-estate loans are the only alternative to more real-estate bankruptcies, and more real-estate bankruptcies are guaranteed to keep the vicious circle going: more bank failures, more crackdowns by bank examiners and more hand-wringing by distraught policy-makers.

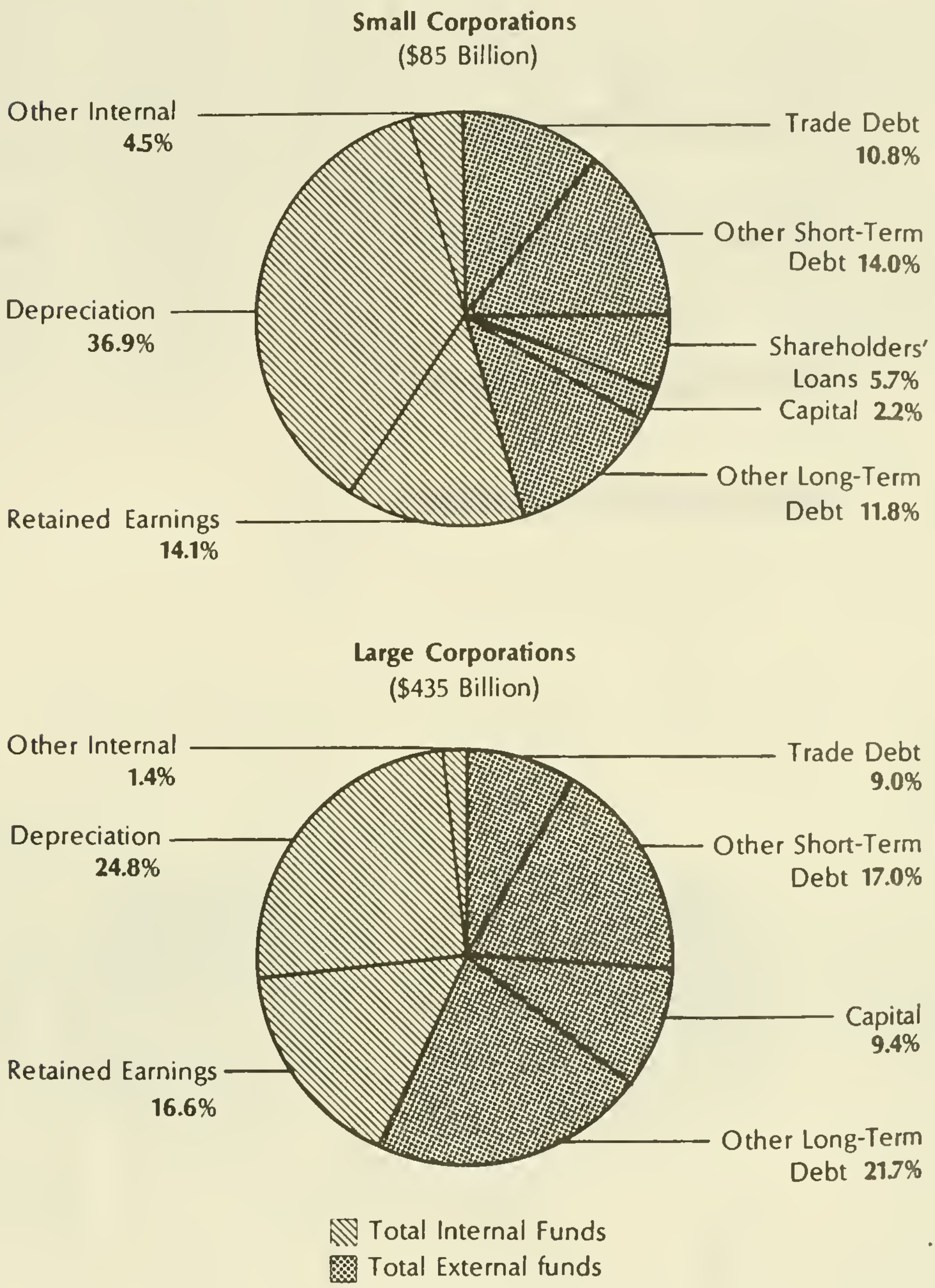
For an administration that pays constant lip service to free-market forces, this one has learned remarkably little about their workings. So long as the savings and loans had money, the banks were happy to grab it. In return, they dumped their real-estate garbage onto the S&Ls. But the legendary shrewdness of Joseph Kennedy was not needed to foresee that once the S&Ls ran out of money, the banks would be stuck carrying this same real-estate garbage and that the drain would run them out of money, too. A crowning irony has left the ideologues who rushed to deregulate banks during the 1980s presiding over their re-regulation by the paper pushers whom free marketeers abhor.

It is comforting to recall that every recession since 1945 has bounced back into a boom. But the reason for this is disturbing. Each recovery has started with a dramatic increase in bank lending, particularly on real estate.

Whatever label the economists may eventually agree upon to describe the difficulties the economy is suffering today, the banks are not free to resolve them by the familiar expedient of increasing loans, particularly on real estate.

That's the unpleasant surprise. The question it raises is whether Washington can find an alternative expedient to release the economy from the credit crunch. The most intelligible resolution of the war of words at the policy level may be the simplest at the administrative level: for the policy-makers to send the bank examiners about their normal business.

Chart 3.2: *Sources of Funds for Small and Large Corporations, 1978–1980 Average*



Source: Data computed from U.S. Department of the Treasury, Internal Revenue Service, *Corporation Source Book of Statistics of Income* (Washington, D.C.: Government Printing Office, various issues).

From the 1984 State of Small Business

Table 3.1 *Typical Balance Sheet*

Left-Hand Side		Right-Hand Side
Current Assets		Current Liabilities
Cash and Equivalent		Accounts Payable
Accounts Receivable		Accrued Expenses (Taxes)
Inventory and Work-in-Process		Short-Term Debt
Prepaid Expenses		
		Long-Term Liabilities
Long-Term Assets		Long-Term Debt
Plant and Equipment		Loans from Shareholders
(Less Depreciation)		
Land		Net Worth
Goodwill, Patents, etc		Capital Stock and
Loans to Shareholders		Paid-in Surplus
		Retained Earnings
Total Assets	equal to	Total Liabilities and Net Worth

ventory). Current assets—normally held for a period of less than one year—accounted for 63 percent of total assets for these small corporations, compared to 40 percent for large corporations (Chart 3.1). Demands for operating capital in a small firm usually leave less of the firm's limited supply of capital available for long-term investment in plant and equipment. To meet the need for working capital, small firms maintain a higher level of current debt to total debt, with a ratio of 0.64 for small corporations compared to 0.50 for large corporations. Not only must small firms rely more on short-term debt, they are also forced to carry more debt overall as shown by a debt-to-equity ratio for small corporations of 2.0, much higher than the ratio of 1.4 for large corporations (Table A3.12).[6]

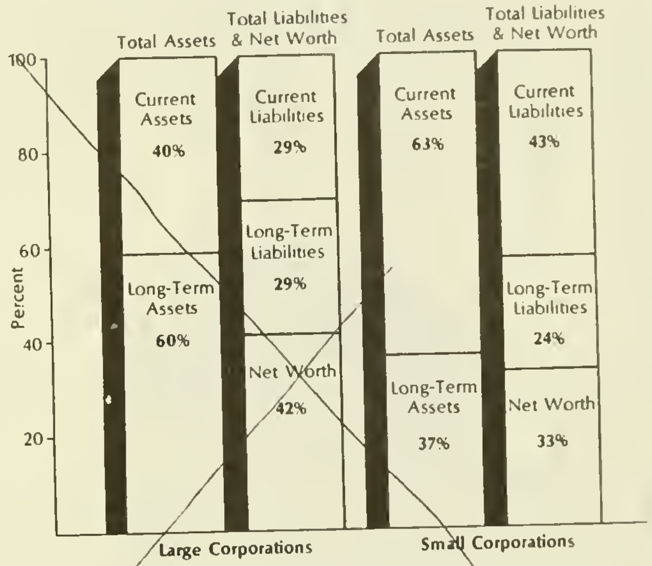
Sources and Uses of Funds

An average of approximately $500 billion of funds was used by U.S. corporations each year from 1978 to 1980 to purchase assets necessary for their businesses.[7] Small and large corporations differed substantially in both the

[6]The debt-equity ratio is the ratio of the sum of short- term plus long-term debt to the book value of stockholder's equity. Some debt of small corporations may be loans from shareholders. Such shareholder loans might occasionally be a form of equity, but for purposes of financial analysis it is treated as equivalent to outside debt.

[7]Total funds supplied always equal total funds used in the flow-of-funds accounting framework.

Chart 3.1: *Percent Distribution of Assets and Liabilities for Small and Large Corporations, 1978–1980 Average*



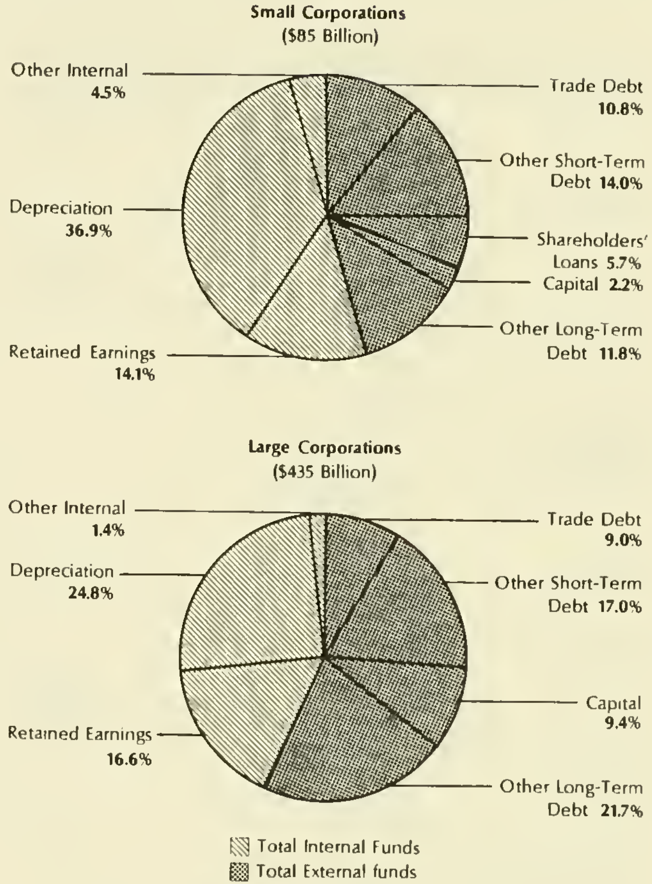
Source: Data computed from U.S. Department of the Treasury, Internal Revenue Service, Corporation Source Book of Statistics of Income (Washington, D.C.: Government Printing Office, various issues).

sources and the uses of funds. Large corporations relied more on external sources of financing, especially on long-term debt and capital, which accounted for about 30 percent of total funds used by large firms (Chart 3.2).

Large corporations generated about 43 percent of their funds internally, while small firms generated 55 percent internally.[8] Retained earnings supplied more funds for large corporations, 16.6 percent compared to 14.4 per-

[8]Internally generated funds include depreciation and retained earnings. Depreciation allowance is a business expense that provides reserve funds for the replacement of worn-out plant and equipment. Retained earnings is that share of after-tax profits not distributed to shareholders.

Chart 3.2: *Sources of Funds for Small and Large Corporations, 1978–1980 Average*



Source: Data computed from U.S. Department of the Treasury, Internal Revenue Service, *Corporation Source Book of Statistics of Income* (Washington, D.C.: Government Printing Office, various issues).

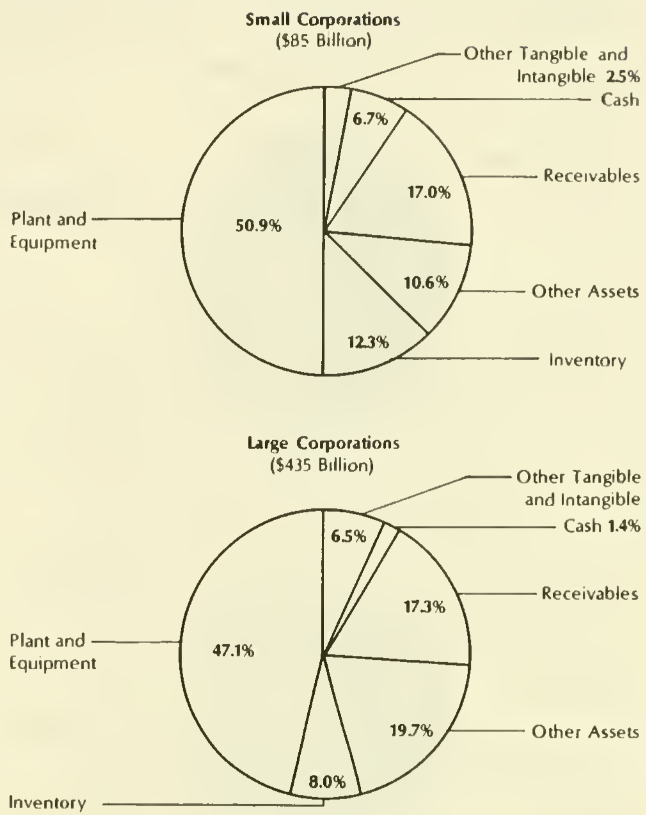
cent for smaller corporations (Tables A3.13 and A3.14). This is because of the higher rate of profit on equity earned by large corporations compared to small corporations. Depreciation was a greater source of funds for small corporations (36.9 percent) compared to larger corporations (24.8 percent). (Tables A3.17 and A3.18)

Externally generated funds also show different patterns for the two sizes of corporations.[9] The amount of funds raised from external capital markets was four times greater for large firms at 9.4 percent than small firms at 2.2 percent. Funds raised in external capital markets usually require substantial registration and underwriting expenses. Because these expenses are almost as great for small amounts of capital as for large amounts, small corporations seldom used these markets. As a result, shareholders in small corporations often made loans from personal funds to maintain the business. These shareholder loans represented 5.7 percent of all funds raised by small corporations but were an insignificant source of funds for large corporations. Calls to the shareholders for these loans by small corporations came most often during periods of financial stress for both the firm and the shareholder. They were asked to contribute personal funds to ensure the viability of the firm. Small firms did not usually use long-term debt, which accounted for only 11.8 percent of funds supplied, compared to 21.7 percent for large firms. Small firms were able to obtain trade credit—loans from suppliers—for 11 percent of their funds, higher than the 9 percent acquired from this source by larger corporations. This difference is slightly less than the difference in funds used for inventory increases.

In times of price inflation, both large and small corporations need funds to increase the dollar value of accounts receivable and inventories to maintain the same real business volume. Large corporations were more likely to purchase other financial assets like commercial paper, short-term Treasury bills, and stock in other firms at 19.7 percent of funds used, compared to smaller corporations at 10.7 percent. Between 1978 and 1980 the liquidity of short-term investments permitted larger corporations to operate with increases in cash holdings only one-fourth as large as small business increases in cash holdings (Chart 3.3). Many markets for short-term invest-

[9] External funds include sale of stock, loans from shareholders and from such conventional sources as suppliers, friends, relatives, and financial institutions.

Chart 3.3: *Uses of Funds for Small and Large Corporations, 1978–1980 Average*



Source: Data computed from U.S Department of the Treasury, Internal Revenue Service, *Corporation Source Book of Statistics of Income* (Washington, D.C.: Government Printing Office, various issues).

ments were open only to large corporations because some of these markets required a million-dollar minimum investment.

In summary, small corporations relied more on internal funds (55.5 percent) compared to large corporations (42.8 percent). If loans from shareholders are not considered as a truly external source of capital and are added to internal sources, it becomes evident that small firms obtain over 61.2 percent of their funds from internal sources and shareholder loans. This means that small businesses obtain about only 39 percent of their required funds outside the present business and its ownership. Large businesses raise 57.2 percent of their funds from outside of the firm. The use of these funds by the two size groups also reflects the flexibility that treasurers of large corporations have through their access to major capital markets. That flexibility extends to cash management and the purchase of short-term debt instruments.

Trends in the Financing of American Corporations, 1966–1980

The U.S. economy experienced several major economic and financial changes during the late 1960s and the 1970s. The rate of increase in the GNP price deflator, the most comprehensive measurement of inflation, grew from an average of 3.1 percent between 1965 and 1967 to 9.3 percent in 1980. The average prime interest rate increased from 5.3 percent in 1966 and 1967 to 15 percent in 1980. Although nominal interest rates rose threefold during this period, real interest rates—the nominal rates minus the rate of inflation—remained low.[10] How did American corporations respond to these major changes in the economy and in the financial market? Did these developments cause a major shift in financing patterns for small and large corporations?

Overall, American corporations seem to have adjusted well to changes in the rate of price inflation that affects the cost of production, the cost of money, changes in the international balance of trade, and cyclical sales patterns. Total business receipts, corporate profits, and total funds used by these corporations grew at an annual compound rate comparable to the growth rate of nominal

[10] It is difficult to provide a statistical measurement of real interest rates for long-term lending/borrowing. Theoretically, the rate of inflation used to deflate the nominal rates should be computed on the basis of the expected rates of inflation during the years of debt duration. However, that is hardly feasible. A conventional method is to use average rates of price increase in the past as an approximation.

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